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Preparing and reporting on cash- and tax-basis financial statements

Michael J. Ramos

American Institute of Certified Public Accountants. Accounting and Auditing Publications Team

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AICPA Practice Aid Series

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Preparing and Reporting on Cash- and Tax-Basis Financial Statements

Written by
Michael J. Ramos, CPA

Edited by
Accounting and Auditing Publications

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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AICPA Practice Aid Series

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PREFACE

The publications that constitute the AICPA Practice Aid Series have been designed to address a broad range of topics that affect today's CPA. From enhancing the efficiency of your practice to developing the new skill sets required for a successful transition to meet the challenges of the new millennium, this series provides practical guidance and information to assist in making sense out of a changing and complex business environment. The talents of many skilled professionals have been brought together to produce what we believe will be valuable additions to your professional library.

ACKNOWLEDGMENTS

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FOREWORD

For many years, financial statements prepared on the cash- or tax-basis of accounting have provided a viable alternative to GAAP-basis financial statements. Properly prepared, cash and tax-basis financial statements offer distinct benefits to—

- *Financial statement users*, who find them understandable and relevant for their various needs

- *Financial statement preparers*, who find them easier and more cost-effective to prepare.

However, unlike generally accepted accounting principles (GAAP), there is little authoritative guidance that explicitly addresses the preparation of and reporting on cash- and tax-basis financial statements. As a result, practitioners frequently struggle with how to apply GAAP to cash- or tax-basis financial statements. The continued proliferation of complex accounting rules—particularly those related to the disclosure of matters not recognized in the financial statements—have exacerbated the practitioner's dilemma.

PURPOSE AND ORGANIZATION OF THIS PUBLICATION

Views on how to apply GAAP to cash- and tax-basis financial statements vary between two extremes.

- Some practitioners believe that GAAP should be applied to all types of financial statements, regardless of the basis of accounting.

- Other practitioners believe that authoritative accounting standards were developed solely for financial statements prepared in accordance with GAAP, and as a result, these standards do not apply to statements prepared on other comprehensive bases of accounting.

This practice aid cannot resolve these differences in viewpoints. Instead, this book is intended to alert the reader to some of the most frequently-encountered issues faced by accounting professionals in dealing with cash- and tax-basis financial statements and provide suggestions and insight into how these issues are resolved in practice.

This guide is comprised of two parts.

- *Part one* includes an introduction to financial statements prepared on an other comprehensive basis of accounting (OCBOA) and a discussion of unique issues for preparing and reporting on cash- and tax-basis financial statements.

- *Part two* includes example financial statements, disclosures and report modifications.

Additionally, an appendix to the publication provides an example disclosure checklist to be used for cash- and tax-basis financial statements.

TERMINOLOGY AND ABBREVIATIONS

Although the contents of this guide focus exclusively on the cash- and tax-bases of accounting, much of our advice can be applied to other comprehensive bases of accounting. As a result, the terms *other comprehensive basis of accounting* and *OCBOA* appear frequently throughout this guide.

OCBOA financial statements are not acceptable for publicly traded companies. This guide is intended for practitioners working with small to medium-sized privately held entities. Terms such as *in practice*, refer to the practical experience of CPAs who work with these types of clients.

Legend of Abbreviations

SFAS: Statement of Financial Accounting Standards

SAS: Statement on Auditing Standards

AU: Reference to section number in *AICPA Professional Standards* (vol. 1)

SOP: AICPA Statement of Position

TPA: AICPA Technical Practice Aid

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WHAT'S AN OTHER COMPREHENSIVE BASIS OF ACCOUNTING?

As used in this context, the term "other" means other than generally accepted accounting principles. SAS No. 62, *Special Reports*, (AU §623) defines the following as other comprehensive bases of accounting.

- *Tax Basis*. The basis of accounting the reporting entity uses (or expects to use) to file its income tax return for the period covered by the financial statements.

- *Cash/Modified Cash Basis*. The cash receipts and disbursements basis of accounting and modifications of the cash-basis having substantial support, such as recording depreciation on fixed assets or accruing current income taxes.

- *Regulatory*. A basis of accounting the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. An example is a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.

- *Other*. A definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.

This publication focuses exclusively on the first two types of OCBOA presentations, the cash- and tax-basis because in practice, these are the most prevalent types of OCBOA financial statements.

Additionally, under SAS No. 62, reports on financial statements prepared in compliance with the requirements of a governmental regulatory agency must be restricted to distribution within the entity and for filing with the regulatory agency. Thus, these types of financial statements are not intended for general use.

Financial Statements That Are Neither
GAAP nor OCBOA

In some instances you may be asked to report on special-purpose financial statements prepared in conformity with a basis of accounting that is neither GAAP nor an OCBOA. SAS No. 62 (AU §623.27) provides examples of the following non-GAAP bases of accounting that are **not** considered an OCBOA:

- A loan agreement that requires the borrower to prepare consolidated financial statements in which assets, such as inventory, are presented on a basis that is not in conformity with GAAP or an other comprehensive basis of accounting.

- An acquisition agreement that requires the financial statements of the entity being acquired to be prepared in conformity with GAAP except for certain assets, such as receivables, inventories, and properties for which a valuation basis is specified in the agreement.

The above situations are not considered OCBOA statements because the criteria used to prepare such financial statements are not considered to be "criteria having substantial support," even though the criteria are definite.

If you are asked to report on these or similar statements, refer to paragraphs 28 through 30 of SAS No. 62 (AU §623.28–.30) for guidance.

WHY ARE CASH- AND TAX-BASIS FINANCIAL STATEMENTS ISSUED?

Typically, entities issue cash- and tax-basis financial statements when they are considered to be a cost-effective alternative to GAAP financial statements. Preparing OCBOA financial statements generally is less costly than preparing GAAP financial statements because of—

- *Less Extensive Disclosure Requirements.* As discussed elsewhere in this guide, OCBOA financial statements do not require all of the extensive disclosures required of GAAP statements. Instead, OCBOA financial statements may provide information that communicates the substance of a GAAP disclosure, which may result in substituting qualitative information for some of the quantitative information required for GAAP presentations.

- *Ability to Prepare Tax Returns and Financial Statements From the Same Information.* When tax-basis financial statements are issued, a significant portion of the cost can be absorbed by the preparation of the tax return. Additionally, the entity is not required to maintain two sets of accounting records.

In practice, the most typical industries in which OCBOA statements are issued include:

- Professional services
- Medical
- Retail
- Real estate
- Manufacturing
- Farming/agricultural

DETERMINING WHETHER TO ISSUE OCBOA FINANCIAL STATEMENTS

Issue #1: Under what circumstances should I consider issuing cash- or tax-basis financial statements?

Cash- or tax-basis financial statements can be prepared whenever the entity is not contractually or otherwise required to issued GAAP financial statements. As a practical matter, you should consider issuing cash- or tax-basis financial statements whenever the following general conditions are met:

- The users of the financial statements—both internal and external to the entity—understand a cash- or tax-basis presentation and find it relevant for their needs.
- It is cost-effective to prepare cash- or tax-basis financial statements.
- The operations of the entity are conducive to a cash- or tax-basis presentation.

Characteristics of Entities That Should
Consider Issuing Cash- or Tax-Basis Financial Statements

Characteristics of entities that generally are good candidates for cash- or tax-basis financial statements are the following.

General Condition	Specific Characteristic
User needs—third party	• The entity has no third-party users of the financial statements (for example, the entity is a small, closely-held business with no third-party debt). • The entity has only secured, rather than unsecured debt. • Creditors of the entity do not require GAAP financial statements.
User needs—owners and managers	• The business is owned by a manager who is closely involved in the day-to-day operations of the business and carries in his or her mind a fairly accurate picture of the entity's financial position. • The owners of the entity primarily are interested in cash flows (for example, a professional corporation of physicians that distributes its cash-basis earnings through salaries, bonuses, and retirement plan contributions). • The owners of the entity primarily are interested in the tax implications of transactions (for example, partners in a partnership who are concerned about the tax effects of transactions that will be reflected on their personal tax returns).
Cost-effective	• The entity's cost of complying with GAAP would exceed the benefits (for example, a small construction contractor who would be required to account for long-term contracts using the percentage-of-completion method and would be required to compute deferred taxes). • The entity is not subject to Internal Revenue Code rules that would require it to prepare its tax return on the accrual basis of accounting. (If the entity is required to use the accrual method for income tax purposes, the differences between a tax-basis presentation and GAAP may not be significant enough to provide substantial cost savings.
Operations	• Capital expenditures and long-term financing are not significant to the entity.

As the preceding table indicates, understanding the needs of the financial statement users is the most important step in helping your clients decide whether to issue OCBOA financial statements. If the users of the financial statements understand an OCBOA presentation, and if the information presented under that basis of accounting is relevant to their needs, then the entity should consider issuing OCBOA financial statements.

> Practice Tip
>
> In some situations financial statement users may be more inclined to accept OCBOA financial statements if the client also provides additional information outside the basic financial statements.
>
> For example, XYZ is a limited partnership that wants to prepare tax-basis financial statements. The partnership borrows under a line of credit whose limit is set according to the level of the partnership's accounts receivable. The lender would prefer GAAP-basis financial statements; however, they might agree to tax-basis presentation if the partnership also provided them with an aged listing of receivables.

Issue #2: Under what circumstances would it be inappropriate to issue OCBOA financial statements?

OCBOA financial statements should not be issued when the entity is or soon will be required to issue GAAP-basis financial statements. For example, public companies or those contemplating going public should issue GAAP-basis financial statements. Although not inappropriate, issuing OCBOA financial statements under these circumstances would be inefficient, as the entity still has an obligation to issue GAAP-basis financials.

Additionally, OCBOA financial statements should not be issued if the results are misleading.

Paragraph .09 of SAS No. 62 (AU §623.09) includes the following guidance.

> *The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting as he or she does to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation.*

In the author's opinion, this statement indicates that an auditor has a responsibility to determine whether the financial statements are misleading. This responsibility cannot be avoided simply by issuing cash- or tax-basis financial statements. OCBOA financial statements are intended to be a cost-effective alternative to GAAP, not a way to deliberately mislead financial statement users.

You should consider whether OCBOA financial statements could be misleading whenever the following conditions are present:

- The entity has substantial unfunded obligations, commitments, and contingent liabilities that would not be recorded on the tax- or cash-basis, or
- The entity has delayed paying accounts payable and other current liabilities not shown on a cash-basis statement, or
- The financial statements have been compiled with substantially all disclosures omitted.

Practice Tip
In the author's opinion, OCBOA financial statements should be prepared and reported on by someone with a strong working understanding of generally accepted accounting principles. Absent a working knowledge of GAAP, it would be difficult to comply with the OCBOA reporting requirements, for example, to make disclosures that communicate the substance of GAAP disclosures.

Example
Possibly Misleading OCBOA Financial Statements

Long Street Partners has typically issued tax-basis financial statements because the partners are more interested in the tax treatment of partnership transactions. Outside creditors have also accepted the tax-basis financial statements as suitable for their needs. During the current year, two events occur that significantly impact the partnership:

- Several large customers experience financial difficulty and the partnership's receivables from the customers are in danger of not being collected. Under generally accepted accounting principles, the partnership would be required to record an allowance and recognize a bad debt expense. Under the tax rules, the partnership uses the direct write-off method, so no deduction would be allowed in the current year.
- The partnership has acknowledged that it is obligated to perform an environmental remediation at one of its sites. Under generally accepted accounting principles, the partnership would be required to recognize the liability and a loss. Under the tax rules, the deduction is not allowed until the amount is paid.

What are the practitioner's options in such a situation? What advice would he or she give the Long Street Partners?

As a practical matter, a practitioner faced with such a situation should consider the following:

- *Intent Matters.* The client's intent in issuing the OCBOA financial statements should be taken into consideration. In this example, the entity had a long history of issuing tax-basis financial statements, which were suitable for the needs of the users. The events in the current year merely illustrate the limitations of tax-basis financial statements.

  Suppose the partnership had *historically issued GAAP financial statements.* In the current year they decide to issue tax-basis statements. Under this set of facts, one has to consider whether the switch to the tax-basis financial statements was done with the intent to mislead financial statement users. A CPA may not want to be involved with a client whose management intentionally tries to deceive financial statement users.
- *Disclosure Helps.* Assuming that the management of Long Street Partners does not want to mislead the financial statement users, the CPA might advise the partnership to increase the amount and type of information included in the notes about these two events. For example, the partnership might disclose the nature of the environmental remediation liability and the amounts involved.
- *Recognition May Be Appropriate.* Depending on the nature and magnitude of the item, it may be appropriate to recognize it in the financial statements. In this example, the partnership might decide to account for bad debts using the allowance method and to recognize a contingent liability for the remediation obligation. This would be a departure from the tax-basis of accounting that would have to be acknowledged in the accountant's report. An auditor would either disclaim an opinion or modify his or her report to indicate a departure from the stated basis of accounting.
- *Consider GAAP Financials.* As a result of the changed circumstances, OCBOA financial statements may no longer be appropriate, and the entity may have to change to GAAP.

DECIDING BETWEEN MODIFIED CASH- OR TAX-BASIS STATEMENTS

In some situations it may be difficult to determine whether to issue modified cash- or tax-basis financial statements. In practice, most OCBOA financial statements are tax-basis, but each basis has its own distinct advantages and disadvantages.

Modified Cash- or Tax-Basis
Advantages and Disadvantages of Each

	Advantages	Disadvantages
Modified Cash-Basis		
	• Can be simpler to prepare than tax-basis • Not affected by changes in tax laws • Interim financial statements are easy to prepare	• Recognition and measurement principles are not well-defined • Not well-suited for entities that have inventory or complex operations.
Tax-Basis		
	• Well-suited for entities with inventory or complex operations • Well-defined recognition and measurement criteria	• Decisions made for tax reporting purposes may have unintended financial reporting effects • Time-consuming to prepare interim financial statements

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OVERVIEW OF AUTHORITATIVE OCBOA LITERATURE AND SUMMARY OF KEY ISSUES

Guidance on OCBOA financial statements is contained in the audit, not accounting, literature. Sources of authoritative guidance are:

- SAS 62, *Special Reports*, AU §623
- Auditing Interpretations, *Special Reports*, AU §9623

Nonauthoritative guidance on OCBOA financial statements can be found in the following:

- This guide

- Technical Practice Aids, Section 1310.10, [Applicability of Statement of Cash Flows to] *Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles*, published by the AICPA

- Technical Practice Aids, Section 1500.05, *Substantial Support for Modifications in Cash Basis*, published by the AICPA

- Technical Practice Aids, Section 9210.10, *Change From Generally Accepted Accounting Principles (GAAP) to An Other Comprehensive Basis of Accounting (OCBOA) or From OCBOA to GAAP*, published by the AICPA

Many issues have arisen in practice for which there is no authoritative guidance. These issues are summarized as follows. A more detailed discussion of these issues is continued in chapters 2, 3, and 4 of this guide.

- *Measurement.* Should nontaxable income and expenses be included in tax-basis financial statements? What cash-basis modifications are considered to have substantial support? At what point do cash-basis modifications become so extensive that the financial statements are really GAAP basis with a departure?

- *Presentation.* OCBOA financial statements are not required to follow exactly the presentation requirements of GAAP. Instead, OCBOA statements can "communicate the substance" of those requirements. What are some alternatives to the GAAP presentation requirements that communicate their "substance?"

  The authoritative literature requires the auditor to consider whether the financial statements that he or she is reporting on are suitably titled. What is considered to be "suitably titled?" Is it appropriate to use titles that are not expressly forbidden?

  How should the financial statements report a change in the basis of accounting, from GAAP in the previous year to OCBOA in the current year?

- *Disclosure.* This is perhaps the most heavily debated issue relating to OCBOA financial statements. Guidance on OCBOA disclosures is contained primarily in AU §623.09 and .10 and Auditing Interpretation 14 (AU §9623.88). These sections of the auditing standards provide some definitive guidance, but also allow OCBOA financial statement preparers to use considerable judgment in providing informative disclosures that are "appropriate for the basis of accounting used," or that "communicate the substance" of GAAP disclosures. The application of this authoritative guidance is discussed in more detail in chapter 3, Presentation and Disclosure Guidelines.

- *Reporting.* Guidance on reporting on OCBOA financial statements is contained in the audit literature. SSARS Interpretation No. 12 (AR §9100) provides guidance on standard compilation and review reports accompanying OCBOA financial statements. In practice, reporting issues have arisen for which there is no guidance. In a compilation or review, how should one modify his or her report in the event of a lack of consistency, or significant uncertainty (including going concern)? See chapter 4.

A REVIEW OF KEY TERMS AND CONCEPTS

Much of the guidance contained in this publication is based on the concepts and logical methods described in GAAP accounting literature. The purpose of this section is to provide you with the background necessary to apply the guidance provided and, in the event you encounter a situation for which guidance has not been provided, to apply sound accounting reasoning to come to an appropriate conclusion.

A basis of accounting (including an "other" basis of accounting) is a framework for determining what and how information is presented in the financial statements and related notes. This framework must address three separate issues.

- *Recognition.* When should an item be incorporated into the financial statements?
- *Measurement.* How will you quantify the item?
- *Presentation and disclosure.* How do you describe the item in the financial statements? What other information should be presented in the notes to prevent the financial statements from being misleading?

Recognition. An item and the information about it should be recognized in the financial statements when the following four criteria are met:

- Definition—The item meets the definition of an element of financial statements.
- Measurability—It has a relevant attribute that can be reliably measured.
- Relevance—The information about it may make a difference to financial statement users.
- Reliability—The information is representationally faithful, verifiable, and neutral.

Measurement. The item must have a relevant attribute that can be quantified monetarily with sufficient reliability. Some items may meet the definition of a financial statement element but may not be measurable. For example, the creation of product awareness by advertising and promotion may result in future benefits—an asset under generally accepted accounting principles. But it will not be recorded as an asset because it fails to meet the measurement criteria. How will you quantify—monetarily—product awareness? If you can quantify it, will that measurement be reliable?

Presentation and Disclosure. Some information is better provided, or can only be provided, by notes to financial statements, by supplementary information, or other means of financial information. For example:

- Information that is essential to understanding the information recognized in the financial statements. For example, a summary of significant accounting policies.

- Information that may be relevant to financial statement users but does not meet all the recognition criteria. For example, the commitments and contingencies.

CHAPTER 2
RECOGNITION AND MEASUREMENT GUIDELINES

Recognition is concerned with determining when an item should be incorporated into the financial statements. This chapter discusses recognition and measurement issues for cash-, modified cash-, and tax-basis financial statements.

CASH-BASIS

Under the cash-basis of accounting, transactions are recognized based on the timing of cash receipts and disbursements. As a result:

- Certain revenue and the related assets are recognized when received rather than when earned, and

- Certain expenses are recognized when paid rather than when the obligation is incurred.

Under the cash-basis, long-term assets are not capitalized, so there is no depreciation or amortization. Accruals are not made and prepaid assets are not recorded. Under the "pure" cash-basis, the Statement of Assets and Liabilities would include only cash and owners' equity.

Typically, the cash-basis presentation consists of a summary of cash receipts and disbursements. In this form of presentation, cash receipts from sales, the incurrence of debt, contributions, and so forth, and the disbursements for debt repayment, expenses, and the purchase of fixed assets are summarized to show the change in cash and cash equivalents for a period.

Pure cash-basis financial statements may be appropriate whenever the entity—

- Is interested primarily in understanding cash flow.

- Has a limited number of financial statement users.

- Has relatively simple operations engaged in one primary activity.

- Does not have significant amounts of debt, fixed assets, or other items that would be recognized under the accrual basis.

Examples of some entities that may use the pure cash-basis of accounting include:

- Estates.

- Trusts.

- Civic ventures.
- Student activity funds.
- Political campaigns and committees.

MODIFIED CASH-BASIS

The modified cash-basis of accounting is a hybrid method that combines elements of the cash and accrual bases of accounting. It is described in SAS No 62 as the pure cash-basis of accounting that includes modifications "having substantial support." For example, a modified cash-basis balance sheet may include the capitalization of long-term assets and inventory, but no accrual of accounts receivable or recognition of prepaid assets.

Issue #3: What cash-basis modifications are considered to have "substantial support"?

SAS No. 62 makes reference to only two modifications as having substantial support: depreciation of fixed assets, and accruing income taxes. Clearly, other modifications have substantial support. Unfortunately, these modifications have not been formalized in the accounting literature, and modifications have evolved through common usage and practice.

An AICPA Technical Practice Aid (Section 1500) offers that a modification would have substantial support if:

- It is equivalent to the accrual basis of accounting, and
- It is not illogical. Interrelated accounts—for example sales and purchases—should be on the same basis. Reporting sales on the cash-basis and cost of sales on the accrual basis would be illogical and may produce misleading financial statements.

Typical Modifications to
Cash-Basis Financial Statements

The following table describes possible cash-basis modifications On the left is a description of the interrelated accounts; on the right, a comment as to how frequently this modification is used in practice. One would have difficulty justifying a modification as having "substantial support" if it is used "rarely" in practice.

Description of Modification	Used in Practice
Capitalize expenditures for property, plant and equipment and record depreciation expense and accumulated depreciation	Frequently
Record liabilities for short- and long-term borrowings and related interest expense	Frequently
Capitalize inventory and use this as a basis for determining cost of goods sold	Occasionally
Report investments at fair value and recognized unrealized gains or losses	Occasionally
Accrue current income tax liability and related income tax expense	Rarely
Record prepaid expenses and the related amortization	Rarely
Accrue other liabilities and related expenses	Rarely

In deciding whether to modify a cash-basis presentation for a particular item, consider:

- The materiality of the item.
- The cost of including the item and the benefit to the financial statement user.
- The results of the modification and whether the financial statements provide meaningful information.

Issue #4: What complications should I be alert for when making cash-basis modifications?

In practice, the following are the most frequent complications that arise when making cash-basis modifications.

Account	Questions to Consider
Inventory	• Should overhead and other indirect expenses be capitalized as part of inventory for modified cash-basis financial statements? • Should a valuation allowance be recorded if cost is greater than net realizable value?
Non-trade receivables	• Should premiums or discounts be recorded to account for note terms that are different from market? • Should a valuation allowance be recorded if the receivable has been impaired under GAAP?
Investments	• Should investments in certain debt and equity securities be reported at fair value and corresponding unrealized gains and losses be recorded?
Property, plant and equipment	• Should interest be capitalized on property, plant and equipment constructed by the entity for its own use? • Should impairment losses be recognized in accordance with GAAP? • What depreciation methods are appropriate?

Practice Tip

The author believes that once a cash-basis modification is made, in general, the entity should follow the generally accepted accounting principles related to the recognition and measurement of that item. For example, if an entity capitalizes fixed assets as a modification to cash-basis financial statements, then any interest that would have been capitalized under GAAP also should be capitalized, and impairment losses should be recognized and measured in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.*

Circumstances may arise in which an entity is justified in deviating from this recommendation. In these situations, you should be sure to describe in the notes to the financial statements the entity's accounting policy and how it differs from GAAP. Quantifying the difference between GAAP and the entity's policy is not required.

Issue #5: At what point do modified cash-basis financial statements become GAAP-basis statements with a departure(s)?

It may be possible that the modifications to a cash-basis statement are so extensive that the financial statements are equivalent to accrual basis financial statements with a departure from GAAP. For example, financial statements that are presented in conformity with GAAP, except that material leases are not capitalized, are not considered modified cash-basis financial statements.

In practice, you will need to use your judgment to determine if modified "cash-basis" statements are "tantamount to financial statements on the accrual basis."

In the author's opinion, the following modifications often indicate that modified cash-basis financial statements are essentially GAAP:

- Trade accounts receivable and payable have been accrued.
- Deferred income taxes and deferred tax expense have been recorded.
- Assets under capital and related obligations have been recognized.

Thus, if a set of financial statements included one of these three modifications, that may be an indication that they are equivalent to GAAP basis with a departure.

Practice Tip

Be alert for instances in which cash- or modified cash-basis statements really are income-tax-basis statements. This frequently occurs when the client uses the cash-basis of accounting for income tax reporting.

If the financial statement amounts agree with the entity's tax return (except that financial statements may include nontaxable income items and nondeductible expenses), you should designate the statements as being on the income-tax-basis of accounting.

TAX-BASIS

The income tax-basis of accounting is based on the principles and rules for accounting for transactions under the Federal income tax laws and regulations. Few new measurement guidelines need to be established because the method is based on tax laws. The income tax-basis of accounting covers a range of alternative bases, from cash to full accrual, depending on the nature of the taxpayer, and in some circumstances, the taxpayer's elections.

In some situations, an entity may be required to pay taxes under the alternative minimum tax (AMT) system rather than the regular tax system. In those situations, most practitioners prepare tax-basis financial statements using the regular tax rules. Disclosures reconciling the difference between the actual tax expense and the tax expected based on income reported in the financial statements are then used to communicate that the entity paid taxes under the AMT rules.

The tax-basis of accounting is most useful for small, nonpublic entities whose financial statement users are interested primarily in the tax aspects of their relationship with the entity. For example, investors in tax-driven partnerships may be primarily interested in the tax consequences of transactions. However, they typically want more information than would be provided by a tax return.

Tax-basis financial statements can be cheaper to prepare than GAAP statements, primarily because CPAs can use the same basic knowledge to prepare both the tax returns and the financial statements.

An entity need not be a taxable entity to prepare tax-basis financial statements. Interpretation 14 of SAS No. 62 (AU §623.91(b)) provides an example of a not-for-profit organization that prepares tax-basis financial statements based on information provided on the entity's Form 990.

Practice Tip

The overall objective of tax-basis financial statements is to present the entity's financial position and results of operations using the recognition and measurement guidelines used for income tax purposes. Thus, tax-basis financial statements are *not* a mere re-formatting of the entity's tax return.

Issue #6: What are the common recognition and measurement issues encountered when preparing tax-basis financial statements?

Nontaxable Revenues and Nondeductible Expenses. Under Federal income tax laws, some transactions are not recognized. For example, receipts such as interest on obligations of state and local governments and proceeds from life insurance policies are not included in revenue. Costs such as premiums paid on officers' life insurance policies are not deductible. When presenting income-tax-basis financial statements, nontaxable revenues and nondeductible expenses should be recognized.

Nontaxable revenues should be recognized when they are received (cash-basis) or when they are earned (accrual basis). Nondeductible expenses should be reported and charged to expense in the period in which they are paid (cash-basis) or when they are incurred (accrual basis).

There are three equally acceptable ways to present nontaxable income and nondeductible expenses in tax-basis financial statements:

- As a separate line item in the revenue and expense sections of the statement of revenues and expenses (In practice, this is the most common presentation.)
- As additions and deductions to net income
- As a disclosure item in the notes

Note that the recognition of nontaxable revenues and nondeductible expenses may result in reporting net income for tax-basis financial statements that differs from taxable income reported on the tax return. In most situations it is not necessary to highlight this difference, for example, by reporting taxable income on the face of the financial statements. If users have a need to know the amount of taxable income, the amount can be disclosed in the notes to the financial statements, or the entity can provide the user with a copy of the tax return.

Additional Income Taxes for Prior Years. An IRS exam may result in additional income taxes being assessed for prior years. Two alternative methods may be used to account for additional taxes for prior years.

- The amount may be charged to expense in the current period if there are no corresponding adjustments to the balance sheet for expenses capitalized or revenue recognized.

- The amount may be treated as a prior period adjustment and charged to retained earnings.

The IRS may disallow amounts charged to expense in prior years and require those amounts to be capitalized and amortized or may require recognition of previously unreported revenue. Such amounts, net of income tax adjustments, should be treated as prior period adjustments. Otherwise, either of the above methods is considered acceptable. The method used should be disclosed.

Accounting Changes for Tax Purposes. For tax purposes, the effects of an accounting change may be recognized prospectively over a specified number of years. Accounting changes should be treated in the same manner as they are treated in the tax return.

S Corporations. Income of an S Corporation is taxable to its shareholders. Consequently, such a corporation may be required to maintain information on distinct classes of retained earnings. However, in tax-basis financial statements, S Corporations usually report retained earnings as a single amount and should report distributions to stockholders.

Issue #7: What should I do if the tax principles and rules produce significantly different results than the recognition and measurement principles under GAAP?

There are many differences between the way items are accounted for under GAAP and the way they are treated under the tax rules. Some of the more common include:

- Bad debt losses on uncollectible receivables.

- Inventory capitalization and valuation.

- Unrealized gains on investment securities.

- Depreciation and impairment of fixed assets.

Occasionally, the differences between the GAAP and tax methods of accounting for these items can be significant and may cause you to question whether the tax-basis financial statements could be misleading. Your options in this situation include:

- *Disclosure.* You are required to disclose how the tax-basis of accounting differs from GAAP. You are *not required* to quantify the difference. However, if you believe that such a disclosure is meaningful and would prevent the financial statements from being misleading, then you should consider asking the entity to disclose the amount of the difference between GAAP and the tax-basis.

- *Recognition.* In some instances, it may be necessary to recognize or measure the item using generally accepted accounting principles. For example, the entity may wish to recognize bad-debt expense using the allowance method required by GAAP, rather than the specific charge-off method required by the tax rules. Following GAAP for this one item is a departure from the tax-basis of accounting, which would require a modification to the accountants' report.

CHAPTER 3
PRESENTATION AND DISCLOSURE GUIDELINES

PRESENTATION

Presentation has to do with how items are presented and described in the financial statements.

Auditing Interpretation 14 offers some broad guidance on how OCBOA financial statements should be presented by stating that OCBOA statements should either comply with GAAP presentation requirements or provide information that communicates the substance of those requirements. The "substance" of the GAAP requirements may be communicated by using qualitative information and without modifying the financial statement format.

For example, an entity preparing GAAP financial statements would have to present a discontinued operation, extraordinary item, or accounting change on the face of the income statement in the manner described in APB Opinion No. 30. In an OCBOA presentation, information about these items could be provided in a note to the financial statements without modifying the format of the actual statements.

The Interpretation also provides the following two examples of how OCBOA financial statements can communicate the substance of GAAP presentation requirements without strictly following GAAP.

- Instead of showing expenses by their functional classifications, the income tax-basis statement of activities of a trade organization could present expenses according to their natural classifications, and a note to the statement could use estimated percentages to communicate information about expenses incurred by the major program and supporting services. A voluntary health and welfare organization could take such an approach instead of presenting the matrix of natural and functional expense classifications that would be required for a GAAP presentation, or, if information has been gathered for the Form 990 matrix required for such organizations, it could be presented either in the form of a separate statement or in a note to the financial statements.

- Instead of showing the amounts of, and changes in, the unrestricted and temporarily and permanently restricted classes of net assets, which would be required for a GAAP presentation, the income-tax-basis statement of financial position of a voluntary health and welfare organization could report total net assets or fund balances, the related statement of activities could report changes in those totals, and a note to the financial statements could provide information, using estimated or actual amounts or percentages, about the restrictions on those amounts and on any deferred restricted amounts, describe the major restrictions, and provide information about significant changes in restricted amounts.

In practice, other presentation issues often must be addressed. This chapter includes a discussion of the common presentation issues that arise when preparing OCBOA financial statements as well as the more fundamental issue of what should be included in a basic set of OCBOA financial statements.

Issue #8: What statements should be presented in a basic set of OCBOA financial statements?

As discussed in chapter 1 of this publication, financial statements that have been prepared on the pure cash-basis of accounting only include a statement of cash receipts and disbursements. In a pure cash presentation, the only asset is cash, so typically it is not necessary to prepare a statement of assets and liabilities.

Modified cash- and tax-basis financial statements will include a statement of revenues and expenses and a statement of assets and liabilities. The statements also should include a statement of changes in the stockholders' equity accounts (or partners' capital accounts, if the entity is a partnership). If these changes consist of only one or two items affecting retained earnings (for example, the only difference in equity is attributable to income) then they may be presented on the statement of revenues and expenses in a way that reconciles retained earnings at the beginning of the period to retained earnings at the end of the period.

Issue #9: Should a statement of cash flows be presented with OCBOA financial statements?

This issue is addressed in Technical Practice Aid section 1300.10 and also, indirectly, in Auditing Interpretation 14 (AU §9623.88).

The statement of cash flows is not a required financial statement under OCBOA. In most circumstances, it is assumed that the interested user can estimate investing and financing activities by analyzing comparative balance sheets. However, when OCBOA financial statement preparers believe that a statement of cash flows would provide useful information to users, then one should be presented. If the entity chooses to present a statement of cash flows, the statement should either conform to the requirements for a GAAP presentation or communicate their substance.

In practice, the decision about whether to include a statement of cash flows is based on—

- *Type of Financial Statement.* In general, practitioners are more likely to include a statement of cash flows in tax-basis financial statements. In instances where the modifications to the cash-basis create material differences between the statement of revenues and expenses and cash flow, a separate statement of cash flows will be prepared, especially when cash flows from operations are not apparent from the other financial statements.

- *Understandability and Usefulness.* If client management and financial statement users understand the statement of cash flows and find the information meaningful, then the OCBOA financial statements should include the information. If a statement of cash flows is not easily understood, irrelevant, or redundant, then it can be eliminated.

Issue #10: Does consolidation accounting apply to cash- and tax-basis financial statements?

- *Tax-Basis Financial Statements.* Tax-basis financial statements are prepared on the basis of accounting the entity uses for income tax purposes. Thus, if the entity files a consolidated tax return, it should report consolidated results on its tax-basis financial statements. If it does not file a consolidated tax return, then it should not report consolidated results.

- *Cash- and Modified Cash-Basis Financial Statements.* There is no authoritative guidance on the circumstances under which cash- or modified cash-basis financial statements should present consolidated results. Professional judgment should be applied to determine which presentation—consolidated, unconsolidated, or possibly combined—provides the most meaningful and relevant information.

  If consolidated statements are presented, then all consolidated entities should use the same basis of accounting. If the entity chooses not to present consolidated statements in a situation where GAAP would require consolidation, then the entity should record the investments using the equity method and provide information about the other entities in the notes to the financial statements. Financial information about the other entities should be presented on the same basis of accounting used to prepare the financial statements.

Issue #11: What titles are appropriate for OCBOA financial statements?

The answer to this question is partially addressed in SAS 62 (AU §623.07). Paragraph 7 of that statement reads as follows:

> .07 Terms such as balance sheet, statement of financial position, statement of income, statement of operations, and statement of cash flows, or similar unmodified titles are generally understood to be applicable only to financial statements that are intended to present financial position, results of operations, or cash flows in conformity with generally accepted accounting principles. consequently, the auditor should consider whether the financial statements that he or she is reporting on are suitably titled. For example, cash-basis financial statements might be titled *statement of assets and liabilities arising from cash transactions,* or *statement of revenue collected and expenses paid,* and a financial statement prepared on a statutory or regulatory basis might be titled *statement of income—statutory basis.* If the auditor believes that the financial statements are

not suitably titled, the auditor should disclose his or her reservations in an explanatory paragraph of the report and qualify the opinion.

The authoritative literature makes it clear that OCBOA financial statements should be appropriately titled so as not to imply that they are GAAP basis statements. Examples of appropriate titles are given, and in practice, these are the titles most commonly used.

No guidance is given as to what constitutes appropriate captions *within* the financial statements. For example, "Statement of Income" is not an appropriate OCBOA financial statement title, but within the statement itself, is it appropriate to use the caption "net income?" For example, should captions such as "excess of revenue collected over expenses paid," excess of expenses paid over revenue collected," and "accumulated excess of revenue collected over expenses paid" be presented?

The author believes that modification of GAAP-basis financial statement captions is not necessary. In practice, GAAP-basis financial statement captions are commonly presented in OCBOA financial statements.

Issue #12: How should you present opening retained earnings when an entity changes from GAAP-basis statements in a prior year to OCBOA statements in the current year?

This issue is addressed in TPA §9210.10. A change from GAAP to OCBOA statements (or vice versa) does not represent a change in accounting principles as described in APB No. 20, *Accounting Changes*. Therefore, no justification for the change is required, and a cumulative effect adjustment is unnecessary. When only the current year's OCBOA statements are presented, there are three ways of presenting opening retained earnings:

- Show opening retained earnings as previously reported in accordance with GAAP, with an adjustment to convert to OCBOA. (In practice, this type of presentation is used most frequently.)
- Show opening retained earnings on the as-adjusted OCBOA basis.
- Show the effects of the adjustment to convert as a cumulative-effect adjustment in the income statement.

If prior year financial statements are presented in comparative form, they should be restated and presented under the basis to which the company has changed. SAS No. 62 specifically states that the effects of the differences between GAAP and OCBOA do not need to be quantified.

In all cases, the change in accounting basis should be disclosed in the notes to the financial statements.

DISCLOSURE

Determining the adequacy of disclosure is probably the most challenging aspect when issuing OCBOA financial statements. Accounting pronouncements will not discuss whether the disclosure requirements apply to OCBOA financial statements. The primary guidance on OCBOA financial statement disclosures is provided in SAS No. 62 and Interpretation 14 (AU §623 and AU §9623). These pronouncements allow for considerable judgment in the nature and extent of OCBOA financial statement disclosure. The guidance on disclosures for OCBOA financial statements is provided in three areas—

- Summary of significant accounting policies
- Disclosures related to items included in the financial statements
- Disclosures related to items not specifically identified on the face of the financial statements

Summary of Significant Accounting Policies. All financial statements, including OCBOA financial statements, should include a summary of significant accounting policies.

Issue #13: What should be disclosed in a summary of significant accounting policies for OCBOA financial statements?

SAS No. 62 requires OCBOA financial statements to include a summary of significant accounting policies. This summary should discuss the basis of presentation and describe how that basis differs from GAAP. However the difference between the basis used and GAAP need not be quantified.

Interpretation No. 14 clarifies that the discussion of the basis of presentation may be brief. In describing the differences between GAAP and the basis used, only the *primary* differences need to be described. Differences that are not significant need not be described.

Generally accepted accounting principles require the entity to disclose the significant accounting policies used to prepare the financial statements, including policies that involve:

- A selection from existing acceptable alternatives.
- Industry peculiarities.
- Unusual or innovative applications of accounting principles.

In practice, this guidance on disclosure of significant accounting policies typically is followed for OCBOA financial statements as well.

The author recommends the following specific disclosures for the summary of significant accounting policies in OCBOA financial statements.

Cash-Basis. The significant accounting policies note for cash and modified cash-basis should also include a discussion of any accrual adjustments or modifications. Modifications or adjustments should have substantial support.

Tax-Basis. The significant accounting policies note for tax-basis financial statements should disclose:

- Whether the basic method of accounting is cash or accrual.
- The tax filing status of the entity, if other than a normal taxable corporation.
- That revenues and related assets and expenses and related obligations are recognized when they are reported or deducted for federal income tax purposes.
- That nontaxable income and nondeductible expenses are included in the determination of net income.
- The nature of any optional tax methods of accounting followed.
- The nature of any important judgments or policies necessary for an understanding of the methods of recognizing revenue and allocating costs to current and future periods.

Interim Financial Statements. Disclosures made in interim financial statements should include information on how inventories and costs of sales were determined. These disclosures also should indicate that deferrals and accruals have been provided only when they would have been provided at year end and, thus, the statements should not be viewed as an indicator of results for the year.

Disclosure of Items Included in the Financial Statements. SAS No. 62 states that when OCBOA financial statements contain items that are the same as or similar to those in financial statements, prepared in conformity with generally accepted accounting principles, *"similar informative disclosures"* are appropriate.

Issue #14: In determining the adequacy of OCBOA financial statement disclosures, what is meant by the phrase "substantially similar informative disclosures"? What information should be disclosed?

Interpretation 14 clarifies this guidance by stating that when OCBOA statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. That may result in substituting qualitative information for some of the quantitative information required for GAAP presentations.

Example
"Similar Informative" Disclosure

The ABC Company issues modified cash-basis financial statements, which include the capitalization of property, plant and equipment. Generally accepted accounting principles require the disclosure of the amounts of major classes of depreciable assets.

Since ABC has issued modified cash-basis financial statements, they are not required to disclose the amounts of their major classes of assets but instead, may communicate the substance of that disclosure, for example.

> *The company owns its headquarters and the related land, which comprise substantially all of the fixed assets reported on the accompanying balance sheet.*

Alternatively, the entity could include ratios or estimated percentages to communicate required disclosure information.

> *The company owns its headquarters and the related land, which account for approximately 75% of the fixed-asset balance reported on the accompanying balance sheet. The remainder of the balance is comprised of office equipment and automobiles.*

If a GAAP disclosure requirement is not relevant to the measurement of an element, account, or item, it need not be considered. For example, if an entity preparing cash- or tax-basis financial statements does not recognize deferred taxes, then the information about deferred tax items required in a GAAP financial statement would not be required to be disclosed.

Interpretation 14 provides two additional examples of situations where GAAP disclosure requirements would not be required because they are not relevant to the measurement of an element, account, or item.

- The fair value information that FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, would require disclosing for debt and equity securities reported in GAAP presentations would not be relevant when the basis of presentation does not adjust the cost of such securities to their fair value.

- The information based on actuarial calculations that FASB Statement No. 87, *Employers' Accounting for Pensions*, would require disclosing for contributions to defined benefit plans reported in GAAP presentations would not be relevant in income tax or cash-basis financial statements.

Practice Tip
Just because an item is not *required* to be disclosed does not mean that it should not be disclosed. If you believe the disclosure of an item is necessary in order to prevent the financial statements from being misleading, or if you believe the additional information is important for the users of the financial statements, you should consider making the disclosure.

Disclosure of Items Not Specifically Identified on the Face of the Financial Statements. SAS No. 62 states that matters that are not specifically identified on the face of the financial statements should be considered for disclosure. These items include related party transactions, restrictions on assets and owners' equity, subsequent events, uncertainties, and other matters that are important for understanding the financial statements.

Related Party Transactions. The existence of related party transactions that are material individually or in the aggregate, and the nature and amounts of the transactions and balances should be disclosed. Note that the tax rules may define "related party" differently than how it is defined under generally accepted accounting principles. The author recommends following the GAAP definition of related party for all financial reporting purposes.

Pension Plans and Commitments and Contingencies. The existence and nature of a pension plan, and material commitments and contingencies should be disclosed.

Assets and Liabilities. Information disclosed for assets and liabilities commonly includes these items:

- Restricted cash, segregated from cash available for current operations, with a description of the nature of the restriction

- The aggregate market value of marketable securities

- Accounts and notes receivable from officers, employees, and affiliates, presented separately with disclosure of the effective interest rate on notes receivable

- The major classes of property, plant, and equipment; depreciation expense for the period; the method(s) used in computing depreciation; and the aggregate, accumulated depreciation

- The method of determining inventory cost (for example, LIFO, FIFO)

Stockholders' Equity. The financial statements often disclose information on stockholders' equity as follows:

- For each class of stock, the number of shares authorized, issued, and outstanding; the par or stated value; and, in summary form, the pertinent rights and privileges of each outstanding class (if more than one class is outstanding)

- The existence of stock option and stock purchase plans

- Restrictions on the payment of dividends

- Changes for the period in the separate components of stockholders' equity

Risks and Uncertainties. SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires a number of disclosures for GAAP financial statements, which are summarized as follows:

- *Nature of Operations.* Entities should disclose a description of the major products or services the reporting entity sells or provides and its principal markets. This information is useful because it helps financial statement users understand the nature of the entity's business and the risks common to that business.

- *General Use of Estimates.* GAAP-basis financial statements should include an explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates.

- *Certain Significant Estimates.* If certain criteria are met, the entity is required to disclose the nature of an uncertainty if it is at least reasonably possible that a change in an estimate will occur in the near term. The purpose of the disclosure is to communicate to financial statement users that there is a good possibility that certain estimated amounts in the current year financial statements will change significantly and impact the next year's financial statements.

- *Vulnerability Due to Certain Concentrations.* If certain criteria are met, the entity is required to disclosed information about its vulnerability due to concentrations, for example, significant volume of business conducted with one customer.

The following table summarizes the author's recommendations for applying the GAAP requirements for disclosing risks and uncertainties in OCBOA financial statements.

Risks and Uncertainties
Disclosure Suggestions for
OCBOA Financial Statements

GAAP Requirement	Author's Recommendation for OCBOA
Nature of Operations	This disclosure is relevant to all OCBOA statements and should be made.
Use of Estimates	This disclosure may not be relevant to some OCBOA financial statements, for example, those prepared on the pure cash-basis that do not include estimated amounts. Do *not* include "boilerplate" language in statements that do not include estimated amounts.
Certain Significant Estimates	If the GAAP disclosure criteria are met, the entity should disclose the information required by the SOP.
Vulnerability Due to Concentrations	May apply to all OCBOA presentations, including pure cash-basis. If the GAAP disclosure criteria are met, the entity should disclose the information required by the SOP.

Practice Tip

If the financial statements do include a disclosure about the use of estimates, make sure it makes proper reference to the basis of accounting used. A common mistake in practice is to make reference to GAAP when disclosing the use of estimates in OCBOA financial statements.

Potential Adjustment From IRS Exams for Tax-Basis Financial Statements. Because of the potential adjustment that could result from an IRS examination, some CPAs include a note disclosure to that effect in their tax-basis financial statements. Consider the following two examples.

> <u>Example One.</u> *These financial statements were prepared on the basis of accounting the company uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles. Because many types of transactions are susceptible to varying interpretations under federal and state income tax laws and regulations, the amounts reported in the accompanying financial statements may be subjected to change at a later date upon final determination by the taxing authorities.*
>
> <u>Example Two.</u> *The corporation prepares its financial statements in conformity with methods of accounting it considers appropriate for federal income tax reporting. As with all tax presentations, these tax accounting methods are subject to review and possible adjustment by the Internal Revenue Service.*

Note that the first example specifically states that the tax-basis of accounting is not GAAP. The first example also explicitly states that amounts reported in the financial statements may change, while the second example says that the accounting methods are subject to review and possible adjustment.

These two examples are general disclosures that apply to all tax-basis financial statements. However, if it is reasonably possible there will be a material change as a result of an IRS exam, you should consider the need to make additional disclosures required by SOP 94-6.

Accounting Changes. The nature and effect on income of an accounting change should be disclosed in the period in which the change is made. Accounting changes consist of changes in the methods of accounting and changes in accounting estimates.

Business Combinations. In the period in which a business combination occurs, information disclosed should include the following:

- The names and brief descriptions of the acquired or combined companies
- Information about any adjustments made to the carrying bases of the assets and liabilities of any of the companies as a result of the combination, as well as the period for which the results of operations of the acquired or combined companies are included in the statement of revenues and expenses
- The consideration given, including the number and type of any shares of stock issued
- Contingent payments, options, and commitments arising from the combination and specified in the related agreement

> Practice Tip
>
> Use a GAAP disclosure checklist as a starting point for determining whether OCBOA financial statements include all the appropriate disclosures. When you come across items that would require disclosure in GAAP financial statements, determine whether these items are relevant to the measurement criteria of the OCBOA or are necessary to prevent the financial statements from being misleading. If information about the item should be disclosed, you should then decide whether to follow the GAAP disclosure requirements or to provide the information in an alternative format that communicates the substance of the GAAP requirements.
>
> (Note: the AICPA publishes a general purpose disclosure checklist, as well as checklists for 13 different specialized industries. For more information, please contact the AICPA at 1-888-777-7077.)

CHAPTER 4
REPORTING CONSIDERATIONS

THE STANDARD AUDIT REPORT

Guidelines for reporting on audited OCBOA financial statements are contained in SAS No. 62. In general, an audit report on OCBOA financial statements will differ from a report on GAAP financial statements in the following ways.

- The financial statements described in the first and the opinion paragraphs will conform to the titles of the OCBOA financial statements. To avoid confusion, OCBOA financial statements should not use titles such as "balance sheet" and "income statement." See chapter 3 for further discussion.

- An extra paragraph describing the basis of presentation is included immediately preceding the opinion paragraph.

- The opinion paragraph makes reference to "presents fairly...on the basis of accounting described in Note X." Note that a common error in practice is to make reference to "presents fairly...in conformity with GAAP."

The following are example reports on audited cash- and tax-basis financial statements:

Cash-Basis

> We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X8 and 19X7, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.
>
> [Standard second paragraph]
>
> As described in Note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.
>
> In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 19X8 and 19X7, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

Tax-Basis

> We have audited the accompanying statements of assets, liabilities, and capital—income tax-basis, of ABC Partnership as of December 31, 19X8 and 19X7, and the related statements of revenue and expenses—income tax-basis and of changes in partners' capital accounts—income tax-basis for the years then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audits.
>
> [Standard second paragraph]
>
> As described in Note X, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.
>
> In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of December 31, 19X8 and 19X7, and its revenue and expenses and changes in partners' capital accounts for the years then ended, on the basis of accounting described in Note X.

Issue #15: If I give an unqualified opinion on a tax-basis financial statement, does that mean I believe the tax accounting used represents acceptable tax practice?

In the author's opinion, yes. If you believe the entity has taken a tax position on a material transaction that cannot be supported, then you should modify your report accordingly for a departure from the tax-basis of accounting. On the other hand, if—after obtaining all the knowledge from your audit—you would be willing to sign the tax return as preparer, then for financial reporting purposes, you can conclude that the financial statements reflect acceptable tax practice.

Standard Review and Compilation Reports. SAS No. 62 and Interpretation 12 of SSARS 1 indicate that OCBOA financial statements should disclose the basis of accounting and a description of how the basis differs from GAAP (the differences need not be quantified). Also, SAS No. 62 requires that auditor's reports on OCBOA statements be modified to state the basis of accounting and that the basis is a comprehensive basis of accounting other than GAAP. Interpretation 12 indicates that no such modification is necessary in review and compilation reports. (Note: paragraph 20 of SSARS 1 requires that the basis of accounting be disclosed in financial statements that omit substantially all disclosures. If such disclosure is not made, the accountant should modify the compilation report to describe the basis of accounting.)

Report Modifications. The circumstances requiring modification to the standard audit report accompanying OCBOA financial statements are as follows (see AU §623.31):

- *Departures From OCBOA.* A departure from an OCBOA can result in either a qualified or adverse opinion. In some cases an entity may deliberately depart from the cash-or tax-basis of accounting in order to prevent the financial statements from being misleading, as discussed in earlier chapters of this publication. Whether the departure improves the usefulness of the reporting is irrelevant—*any* departure from the OCBOA, assuming it's material, will require a modification of the standard audit report.

- *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application, and assuming the change is relevant, you should add an explanatory paragraph to the report, following the opinion paragraph. This paragraph should describe the change and refer to the related note disclosure. See AU §508.34 through .36 for additional guidance.

- *Uncertainties.* If the financial presentations are affected by uncertainties about future events and the outcome of these events can not be reasonably estimated at report date, you should add an explanatory paragraph. This paragraph would follow the opinion paragraph.

  Keep in mind that uncertainties may lead you to disclaim an opinion. See AU §508.16 through .33 for further guidance

- *Going Concern Uncertainties.* If you have substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statement, you should add an explanatory paragraph after the opinion paragraph of the report. See AU §341.

Practice Tip

OCBOA presentations can affect ratio, trend and other analyses performed on the financial statement amounts. For example, working capital deficiencies or negative trends and ratios may not be as apparent in an OCBOA presentation as they would be under a GAAP presentation. Be alert for this situation when evaluating OCBOA financial statements for possible going concern issues. You may need to look beyond the amounts presented in the financial statements to perform your analysis.

- *Other Auditors.* When you decide to make reference to the report of another auditor as a basis, in part, for your opinion, you should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing your opinion. See AU §508.12 and .13

- *Comparative Financial Statements.* If you express an opinion on prior-period financial statements that is different from the opinion you previously expressed on that same information, you should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph preceding the opinion paragraph.

- *Suitable Titles.* As discussed in chapter 3, OCBOA financial statements should be appropriately titled so as not to imply that they are GAAP statements. If you believe that the financial statements are not suitably titled, you should disclose your reservations in an explanatory paragraph and qualify your opinion. See AU §623.07.

- *Appropriate Disclosures.* Your opinion should be based on your judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation. See AU §623.09. Also see chapter 3 for a discussion of OCBOA financial statement disclosures.

Issue #16: Is a change from GAAP to OCBOA a situation that requires a modification to the standard report?

No. If a client switches from GAAP to OCBOA, you are not required to modify an audit report. However, you may consider adding an explanatory paragraph that highlights:

- A difference in the basis of presentation from that used in prior years, or

- That another report has been issued on the entity's financial statements prepared in conformity with another basis of presentation, for example, when cash-basis financial statements are issued in addition to GAAP financial statements. See footnote 33 of SAS 62.

A sample explanatory paragraph for an audit report on comparative financial statements in the year of change to an OCBOA follows:

> As discussed in Note X to the financial statements, in 19X8 the Company adopted a policy of preparing its financial statements on the accrual method of accounting used for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles. The financial statements for 19X7 have been restated to reflect the accrual method income tax-basis of accounting adopted in 19X8.

Issue #17: Is a change in tax law considered to be a change in accounting principle?

No. A change in the tax law is not considered to be a change in accounting principle for which you would need to add an explanatory paragraph. Disclosure may be necessary.

Issue #18: What other report modifications are common?

You may come across a situation where the entity has departed from the stated OCBOA accounting method. For example, a tax-basis financial statement may include an allowance for doubtful accounts or unearned income. Or a cash-basis financial statement may include the capitalization of fixed assets but no depreciation expense. In these situations, it may be appropriate to modify your report for a departure from the basis of accounting.

As with reports on financial statements prepared in accordance with GAAP, there may be other instances where you wish to add an explanatory paragraph to emphasize a matter regarding the financial statements.

Issue #19: Do audit report modifications apply to compilations and reviews?

The circumstances requiring modification to the standard compilation or review report are the same as those that require modification to the standard auditor's report with the following exceptions:

- Modifications stating the basis of accounting used and that the basis is a comprehensive basis other than GAAP is not required unless the financial statements omit such disclosures.
- Normally, neither an uncertainty (including a going concern uncertainty) nor an inconsistency in the application of accounting principles would cause the accountant to modify the standard compilation or review report, as long as the financial statements appropriately disclose the matters. However, you are not precluded from adding a paragraph to emphasize a matter regarding the financial statements. See AR §100.40, paragraph 14.

In situations in which a client changes its basis of accounting from GAAP to OCBOA or vice versa, you generally would not modify your review or compilation report.

PART TWO:

ANNOTATED EXAMPLES

CHAPTER 5
EXAMPLE FINANCIAL STATEMENTS

This chapter contains nine cash- or tax-basis financial statements from a variety of different types of entities. These financial statements illustrate a number of key points made in chapters 1 through 4 of this publication. Each financial statement has been annotated to highlight these key points.

Name of Entity	Type of Entity	Basis of Preparation
The Children's Center	Not-for-Profit	Modified Cash
Fallston Fire Protection District	Governmental	Modified Cash
Fisher Farms, Inc.	Agricultural	Modified Cash
Alexander & Ames	Limited Partnership	Tax
Riggs & Riggs Realty	Real Estate Partnership	Tax
Miller Medical Equipment	S Corporation	Tax
Maxon Contractors, Inc.	Construction Contractor	Tax
Emma N. Chipman 1964 Irrevocable Trust	Trust	Tax
Hudson Street Partners	Real Estate Partnership	Tax

THE CHILDREN'S CENTER
FINANCIAL STATEMENTS
AS OF AND FOR THE YEAR ENDED
AUGUST 31, 19X8

Author's Note. The following statements of a not-for-profit organization have been prepared on the modified cash-basis. These statements illustrate the following.

- *The financial statements include a statement of functional expenses, which is required by GAAP. As indicated in Interpretation 14 of NAS No. 62, OCBOA financial statements are not required to include such a statement, but may instead communicate the substance of that requirement.*

  For example, the entity might have presented expenses by their <u>natural</u> classification on the statement of revenues, expenses, and changes in net assets. A note to the financial statements could then summarize expenses by their functional classification. That note could present either amounts or percentages. (The example disclosures section of this publication includes two examples of this type of disclosure.)

- *GAAP requires not-for-profit organizations to report the amount of unrestricted, temporarily restricted, and permanently restricted net assets on the face of the balance sheet. The following OCBOA statements do not follow those presentation requirements but instead, communicate their substance by providing relevant information in the notes.*

In reading the notes to these financial statements, you may wish to take note of the following.

- *The notes include disclosures related to the allocation of joint costs. These disclosures are required by SOP 98-2, <u>Accounting for Costs of Activities of Not-For-Profit Organizations and State and Local Governmental Entities That Include Fund Raising</u>, which is effective for financial statements for years beginning on or after December 15, 1998. The SOP requires the disclosure of certain amounts of joint costs. The example disclosure communicates the substance of those requirements by reporting percentages.*

Independent Auditor's Report

To the Board of Trustees of
The Children's Center

We have audited the accompanying statement of assets and net assets—modified cash-basis of The Children's Center (the "Center") at August 31, 19X8 and the related statement of revenue, expenses and changes in net assets—modified cash-basis and of functional expenses—modified cash-basis for the year then ended. These financial statements are the responsibility of the Center's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, the Center's policy is to prepare its financial statements using the modified cash-basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and net assets of The Children's Center at August 31, 19X8 and its revenue, expenses and changes in net assets for the year then ended on the basis of accounting described in Note 1.

[Signature of Firm]

[City and State]

[Date]

The Children's Center

Statements of Assets, and Net Assets—
Modified Cash Basis

August 31, 19X8

Assets

Cash and cash equivalents	$ 306,258
Restricted cash	108,084
Property and equipment (net of accumulated depreciation of $928)	9,018
Deposits	10,000
	$ 433,360

Net Assets

Net Assets	$ 433,360

See accompanying notes to financial statements.

The Children's Center

Statements of Revenue, Expenses and Changes in Net Assets— Modified Cash Basis

August 31, 19X8

Revenue	
Corporate and foundation contributions	$ 536,134
Solicited contributions	235,920
Exchange club projects	105,302
Unsolicited and other donations	69,754
Total revenue	947,110
Expenses	
Program services:	
Parent aide	333,674
Parent education	202,486
Public awareness	143,282
Community education	89,984
	769,426
Supporting services:	
Management and general	100,718
Fund raising	55,264
	155,982
Total expenses	925,408
Increase in net assets	21,702
Net assets, beginning of year	411,658
Net assets, end of year	$ 433,360

See accompanying notes to financial statements.

The Children's Center

Notes to Financial Statements

August 31, 19X8

Note 1—Summary of Significant Accounting Policies and Nature of Activities

Nature of Activities

The Children's Center (the "Center") is a nonprofit corporation incorporated under the Texas Non-Profit Corporation Act. The purpose of the Center is to use its fund exclusively for charitable, scientific and educational purposes, especially the prevention of child abuse.

Basis of Accounting

The records of the Center are maintained on the modified cash-basis of accounting and the accompanying statements have been prepared on that basis. Except for depreciation and deferred revenues all transactions are recognized as either revenue or expenses. Noncash transactions except depreciation are not recognized. The modified cash-basis differs from generally accepted accounting principles primarily because certain revenues are recognized when received rather than when earned and certain expenses are recognized when paid rather than when the obligation is incurred.

Property and Equipment

Property and equipment are recorded at cost and consist of the office building and equipment. Depreciation is computed on the straight-line method based on estimated useful lives of 30 years and five years, respectively.

Cash Equivalents

The Center considers all highly liquid debt instruments with a maturity of three months or less to be cash equivalents.

Contributions

The Center records contributions and grants when received.

Contributed Services

Many individuals volunteer their time to help the Center with its educational activities. During the year ended August 31, 19X8, the Center received approximately 200 volunteer hours that have not been recorded in the statement of revenue, expenses and changes in net assets.

Functional Expenses

The costs of providing the various programs, fund-raising and other activities have been summarized on a functional basis in the statement of functional expenses. Accordingly, certain costs have been allocated among the programs and fund-raising activities benefited. Functional expenses are allocated to programs and supporting services based on specific identification. Expenses that relate to more than one program or support activity are allocated based on salary expenditure.

Income Taxes

The Center is exempt from Federal and State income taxes under Internal Revenue Code Section 501 (c)(3). Accordingly, no provision for income taxes has been made in the financial statements.

Use of Estimates

The preparation of financial statements in accordance with the modified cash-basis of accounting requires management to make estimates and assumptions that affect financial statement amounts and disclosures. Actual results could differ from those estimates and assumptions.

Note 2—Commitments and Contingencies

The Center's offices are located in a building that was donated to the Center in December, 19X8. The land on which the building is located is being leased on a month-to-month basis at a monthly rate of $700. See Note 3.

Note 3—Subsequent Events

In July, 19X8 the Center entered into a "purchase and sale agreement" which provided for the purchase of a building in the amount of $230,000 and the assumption of a lease of the land on which the building is located. The building purchase was executed on September 28, 19X8 and was financed in part by a $220,000 note payable to a bank. The terms of the note provide for quarterly interest payments at the bank's prime rate through the note maturity date. A $100,000 principal payment was due and made in December, 19X8, and the remaining balance is due September, 19X4. The note is secured by a leasehold deed of trust and security agreement and an assignment of rents and leases.

The assumed lease referred to above is an operating lease that requires annual payments of $19,600 through September, 19X6. The Center has the option to terminate the lease in March, 200X. If the lease is not terminated, the annual payment will be revised to reflect six percent of the value of the land, which will be determined as set forth in the lease agreement.

In February, 19X9, the Center entered into a construction contract for $138,000 to design and construct certain building and leasehold improvements.

Note 4—Temporarily Restricted Net Assets

At August 31, 19X8, net assets include $107,934 that the Center has not yet expended in the manner specified by the donors. During the fiscal year ended August 31, 19X8, the Center expended $8,413 in restricted funds in accordance with donor restrictions.

Temporarily restricted net assets are available for the following purposes or periods.

Operations for fiscal X9	$	35,000
Construction of building improvements		15,000
Parent aid		47,934
Public awareness		10,000
	$	107,934

Note 5—Allocation of Joint Costs

During the year ended August 31, 19X8, the Center conducted activities that included appeals for contributions and incurred joint costs of approximately $46,000. These activities included direct mail campaigns and special events. Approximately 65% of these joint costs were allocated to fund raising activities, 25% to community education, and 10% to parent education.

**FALLSTON FIRE PROTECTION DISTRICT
COMBINED FINANCIAL STATEMENTS
AS OF AND FOR THE YEAR ENDED
JUNE 30, 19X8**

Author's Note. The following statements of a governmental entity have been prepared on the "pure" cash-basis. These statements illustrate the following.

- *The presentation of the financial statements essentially conforms to a GAAP presentation for a governmental entity.*

- *Typically, a balance sheet on the pure cash-basis includes only cash and equity, and for that reason, pure cash-basis financial statements usually do not include a balance sheet. However, in this instance, a cash-basis balance sheet has been presented in order to report fixed assets in the general fixed asset account group. Consistent with governmental accounting standards, no depreciation of fixed assets is recorded, so the statement of revenues and expenses includes no depreciation expense.*

Independent Accountant's Report

To the Board of Directors of
Fallston Fire Protection District

We have compiled the accompanying combined statement of assets, liabilities, and fund balances (arising from cash transactions) of Fallston Fire Protection District as of June 30, 19X8 and the related combined statement of revenues, expenditures, and changes in fund balance (arising from cash transactions) and combined statement of revenues, expenditures, and changes in fund balance—budget and actual (arising from cash transactions) for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. These financial statements have been prepared on the modified cash-basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting information in the form of financial statements that is the representation of the management of Fallston Fire Protection District. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[Signature of Firm]

[City and State]

[Date]

Fallston Fire Protection District

Combined Statement of Assets, Liabilities, and Fund Balances
All Fund Types and Account Group
(Arising from Cash Transactions)
June 30, 19X8

	Governmental Fund Types		General Fixed Assets Account Group	Totals (Memorandum Only)
	General	Capital Project		
Assets				
Cash and investments—Notes 1 and 3	$ 236,034	$ 361,812	$ —	$ 597,846
Fixed assets—Notes 1 and 4	$ —	$ —	$ 1,575,232	$ 1,575,232
	$ 236,034	$ 361,812	$ 1,575,232	$ 2,173,078
Fund Equity				
Investment in general fixed assets	$ —	$ —	$ 1,575,232	$ 1,575,232
Fund balance—undesignated	$ 236,034	$ 361,812	$ —	$ 597,846
	$ 236,034	$ 361,812	$ 1,575,232	$ 2,173,078

See accompanying notes and accountant's compilation report.

Fallston Fire Protection District

Combined Statement of Revenues, Expenditures, and Changes in Fund Balance—All Governmental Fund Types (Arising from Cash Transactions) Year Ended June 30, 19X8

	Governmental Fund Types		Totals
	General	Capital Project	(Memorandum Only)
Revenues			
Taxes	$ 716,680	$ —	$ 716,680
Ambulance Fee	247,794	—	247,794
Miscellaneous	32,408	—	32,408
	996,882	—	996,882
Expenditures			
Public safety	791,454	—	791,454
Capital outlay	17,734	—	17,734
	809,188	—	809,188
Excess of revenues over expenditures	187,694	—	187,694
Other financing sources (uses)			
Operating transfers in	—	100,000	100,000
Operating transfers out	(100,000)	—	(100,000)
	(100,000)	100,000	—
Excess of revenues and other financing sources over expenditures and other uses	87,694	100,000	187,694
Fund balance, beginning of year	148,340	261,812	410,152
Fund balance, end of year	$ 236,034	$ 361,812	$ 597,846

See accompanying notes and accountant's compilation report.

Fallston Fire Protection District

Notes to Financial Statements

June 30, 19X8

Note 1—Summary of Significant Accounting Policies

Basis of Accounting

The District uses the cash-basis of accounting for preparation of financial statements and budgeting. Under the cash-basis of accounting, revenues are recognized when they are received rather than when they are earned, and expenditures are recognized when paid rather than when the obligation is incurred.

Scope of Reporting Entity

The District has developed criteria to determine whether outside agencies with activities that benefit the citizens of the District should be included within its financial reporting entity. The criteria include, but are not limited to, whether the District exercises oversight responsibility on financial interdependency, selection of governing authority, designation of management, ability to significantly influence operating and accountability for fiscal matters, scope of public service and special financing relationships.

The District has determined that no outside agencies meet the above criteria.

Budget Procedures

A budget is prepared for each fund in accordance with the cash-basis of accounting and legal requirements set forth in the Oregon Local Budget Law. Budget amounts shown in the financial statements include the original and supplemental budget amounts and all appropriation transfers approved by the Board of Directors.

The District employs the following procedures in establishing the budgetary data reflected in the financial statements.

The appointed budget officer develops a proposed budget for submission to the budget committee appointed by the Board of Directors. The operating budget includes proposed expenditures and the means for financing them for the upcoming year, along with estimates for the current year and actual data for the two preceding years.

After the proposed budget is prepared, the budget officer publishes a "Notice of Budget Committee Meeting" in at least one newspaper of general circulation. At the budget committee meeting, the budget message is delivered explaining the proposed budget and any significant changes in the District's financial position. The budget committee meets thereafter as many times as necessary until the budget document is completed.

After approval by the budget committee and the required public hearing, and prior to July 1, the budget is adopted by the Board of Directors, and appropriations are enacted by resolution. Appropriations control expenditures in broad categories as required by Oregon Local Budget Law. More detailed classifications of budgeted expenditures are adopted for administrative control purposes. Budget appropriations lapse at year end.

The governing body is authorized to transfer appropriations within any fund by resolution. Revisions that increase total expenditures in any fund may be made only through a supplemental budget. The procedures for adopting an original budget are also followed for adopting a supplemental budget. No supplemental budgets were adopted during the year.

Expenditures may not legally exceed budget appropriations at the following legal level of control for each department in each fund:

Personal services
Materials and services
Capital outlay

Appropriations are made at the same level of control described above.

General Fixed Assets

Fixed assets are recorded at cost. In accordance with governmental accounting standards, no depreciation of fixed assets is recorded.

General fixed asset purchases are recorded as expenditures in governmental funds and capitalized in the General Fixed Assets Account Group. Maintenance and repairs are charged to expenditures in various budgetary funds as incurred and are not capitalized. Upon disposal, the General Fixed Assets Account Group is relieved of the assets' estimated original cost or other basis; any receipt from such disposal is accounted for as revenue of the General Fund.

Cash and Investments

District monies are invested as allowed by Oregon Statute. Presently all investments are in bank short-term investments, the Local State Government Investment Pool, and U.S. Government obligations.

Investments are stated at cost; market value of investments is approximately the same as cost.

Property Taxes

Fallston County assesses, collects, and distributes property taxes for all local governments within the County. Property taxes are billed in October of each year. Unpaid personal and real property taxes become liens against the property on January 1 and July 1, respectively. Property taxes are payable in three installments due November 15, February 15, and May 15. A 3% discount is allowed for full payment by November 15. Interest at 16% annually is charged for late payments.

Income Taxes

The District is a municipal corporation exempt from federal and state income taxes.

Other Information

Fire protection and ambulance services are provided through an agreement with the Fallston City Fire Department. The District pays one-half of the salaries and fringe benefits of the City fire personnel. The City provides personnel to operate the District fire equipment.

The District does not employ anyone. The firemen are employees of the City of Fallston.

The District does not directly contribute to any pension plans, however it does reimburse the City of Fallston for one-half of the pension costs related to City fire personnel.

Expenditures may not legally exceed budgeted appropriations of each expenditure category.

All interest income is reported as revenue of the General Fund.

Note 2—Organization and Fund Structure

The District was organized under the laws of the State of Oregon relating to Fire Districts and Rural Fire Districts. The District was proclaimed organized by the Fallston County Court as formed by an election held November 7, 19Y0.

The government is vested in five board members. Each board member is elected for a term of four years.

The accounts of the District are organized on the basis of funds and account groups, each of which is considered to be a separate entity. The operations of each fund are accounted for by providing a separate set of self-balancing accounts which are comprised of each fund's assets, liabilities, fund equity, revenues, and expenditures, as appropriate. Government resources are allocated to and for individual funds based upon the purpose for which they are to be spent and the means by which spending activities are controlled.

The funds and account groups of the District consist of the following:

General Fund

This fund is used to finance the general operations of the District and, subject to restrictions of the Local Budget Law, its assets may be transferred to another fund for any authorized purpose. The principal revenue source is a tax levy.

Capital Project Fund

This fund accounts for cash accumulated to purchase fixed assets.

General Fixed Assets Account Group

This account group accounts for the investment in fixed assets of the District.

The "Totals (Memorandum Only)" column in the combined financial statements is provided for information only and should not be considered consolidated totals.

Note 3—Cash and Investments

Cash and investments consisted of the following at June 30, 19X8:

Cash on hand	$ 200
Checking account	4,140
State local government investment pool	193,306
Farm Credit Discount note	400,200
Total	$ 597,846

The Farm Credit Discount note is an obligation of the U.S. Government. The note was purchased May 20, 19X8 for $400,200. The note matures May 10, 19X9 at par value of $420,000; the effective annual yield is 5.0466%.

Note 4—Fixed Assets

Fixed assets and related changes therein consisted of the following:

	Balances June 30, 19X7	Additions	Disposals	Balances June 30, 19X8
Building	$ 488,510	$ —	$ —	$ 488,510
Vehicles	849,038	11,784	—	860,822
Equipment	219,950	$ 5,950	—	225,900
Totals	$ 1,557,498	$ 17,734	$ —	$ 1,575,232

FISHER FARMS, INC.
FINANCIAL STATEMENTS AND SUPPLEMENTARY INFORMATION
YEARS ENDED JUNE 30, 19X8 AND 19X7

Author's Note. The following financial statements of an agricultural entity have been prepared on the modified cash-basis. These statements illustrate the following—

- *The financial statements have been described as "cash-basis" when, in fact, the cash-basis has been modified to capitalize property and equipment and record depreciation. In practice, the term "cash-basis" frequently is used to describe modified cash-basis financial statements.*

- *The financial statements include supplementary information, which has been prepared on the same basis of accounting used to prepare the financial statements. The accountant's review report includes a fourth paragraph relating to the supplementary information.*

- *The financial statements do not include a statement of cash flows. As discussed in chapter 4 of this publication, a statement of cash flows is not required for an OCBOA presentation. However, note that the preparers of these financial statements have included information similar to that provided in a statement of cash flows. For example, the Statements of Retained Earnings present contributions from and distributions to stockholders at their gross amounts, similar to what would be provided in a statement of cash flows. The amount of depreciation expense is presented in the supplementary schedule, which allows users to determine the cash flow provided by operations.*

In reading the notes to these financial statements, you may wish to take note of the following.

- *The notes include a disclosure about certain significant estimates required by SOP 94-6.*

Independent Accountant's Report

To the Stockholders
Fisher Farms, Inc.
Daytona Beach, Florida

We have reviewed the accompanying statement of assets, liabilities, and stockholder's equity—cash-basis of Fisher Farms, Inc. as of June 30, 19X8 and 19X7, and the related statements of revenues and expenses—cash-basis and of retained earnings—cash-basis for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of Fisher Farms, Inc.

A review consists principally of inquiries of Company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the cash-basis of accounting, as described in Note 1.

Our reviews were made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the cash-basis of accounting, as described in Note 1. The information included in the accompanying schedule of operating expenses—cash-basis is presented only for supplementary analysis purposes. Such information has been subjected to the inquiry and analytical procedures applied in the reviews of the basic financial statements. This information is presented on the cash-basis of accounting, and we are not aware of any material modifications that should be made thereto.

[Signature of Firm]

[City and State]

[Date]

Fisher Farms, Inc.

Statements of Assets, Liabilities and Stockholders' Equity—Cash Basis
June 30, 19X8 and 19X7

	19X8	19X7
ASSETS		
Current Assets		
Cash	$ 923,908	$ 1,134,952
Deposits	—	86,610
Note receivable	39,306	1,208
Employee loans receivable	14,220	19,194
Note receivable—Ken Fisher	37,114	—
Total current assets	1,014,548	1,241,964
Property and Equipment		
Building and improvements	1,628,132	1,622,650
Machinery and equipment	6,743,023	6,587,232
Livestock	6,200	6,200
Autos and trucks	2,685,680	2,545,996
Communication devices	69,636	56,650
Office furniture and fixtures	617,644	473,632
	11,750,315	11,292,360
Less: Accumulated depreciation	9,306,984	8,734,994
Total property and equipment	2,443,331	2,557,366
Other Assets		
Utility deposits and bonds	1,430	1,990
Note receivable	41,519	76,420
Investments—stocks	—	20,000
Total other assets	42,949	98,410
Total assets	$ 3,500,828	$ 3,897,740

See accountant's review report and notes to financial statements.

Fisher Farms, Inc.

Statements of Assets, Liabilities and Stockholders' Equity—Cash Basis June 30, 19X8 and 19X7

	19X8	19X7
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Employee savings payable	$ 1,300	$ —
Stockholders' Equity		
Common stock, 5,000 shares authorized, 800 shares issued, 600 shares outstanding, par value $1	800	800
Retained earnings	3,874,628	4,272,840
Treasury stock	(375,900)	(375,900)
Total stockholders' equity	3,499,528	3,897,740
Total liabilities and stockholders' equity	$ 3,500,828	$ 3,897,740

See accountant's review report and notes to financial statements.

Fisher Farms, Inc.

Statements of Revenues and Expenses—Cash Basis
Years Ended June 30, 19X8 and 19X7

	19X8	19X7
Revenues		
Produce sales	$36,334,334	$32,193,282
Product handling income	—	5,236
Harvest and sharecrop income	565,532	971,738
Discounts earned	259,686	163,782
Fuel tax refunds	3,270	4,118
Insurance claims	4,014	4,262
Miscellaneous income	10	38
Total revenues	37,166,846	33,342,456
Operating expenses	41,283,040	38,422,016
Loss from operations	(4,116,194)	(5,079,560)
Other revenues and (expenses)		
Gain on sale of assets	560	1,862
Interest earned	29,428	29,654
Rental income	32,200	80,330
Loss on marketable security	(20,000)	—
Casualty loss	(9,832)	—
Total other revenues and (expenses)	32,356	111,846
Net loss	$(4,083,838)	$(4,967,714)

See accountant's review report and notes to financial statements.

Fisher Farms, Inc.

Statements of Retained Earnings—Cash Basis
Years Ended June 30, 19X8 and 19X7

	19X8	19X7
Retained earnings, beginning of year	$ 4,272,840	$ 7,825,904
Net loss	(4,083,838)	(4,967,714)
Add: Contributions from stockholders	10,310,000	18,570,000
Less: Distributions to stockholders	(6,624,374)	(17,155,350)
Retained earnings, end of year	$ 3,874,628	$ 4,272,840

See accountant's review report and notes to financial statements.

Fisher Farms, Inc.

Notes to Financial Statements

June 30, 19X8 and 19X7

Note 1—Summary of Significant Accounting Policies

Nature of Operations

Fisher Farms, Inc. is an agricultural business located in Daytona Beach, Florida. The Corporation raises vegetables that are distributed to brokers for marketing throughout North America.

Basis of Accounting

Assets and liabilities are recorded and revenues and expenses are recognized on the cash-basis, modified for the capitalization of fixed assets and their depreciation; consequently, certain revenues are recognized when received rather than when earned, and certain expenses are recognized when paid rather than when the obligation is incurred.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation computed on the declining balance and straight-line methods. The assets are depreciated over their estimated useful lives, which range from five to 35 years. Gains and losses from property and equipment dispositions are recognized when the assets are sold or abandoned.

Income Taxes

The Corporation, with the consent of its stockholders, has elected to have its income taxed under Section 1372 of the Internal Revenue Code, which provides that, in lieu of corporation income taxes, the stockholders are taxed on their proportionate share of the Corporation's taxable income. Therefore, no provision or liability for federal income taxes is reflected in the accompanying financial statements.

Use of Estimates

The preparation of financial statements in conformity with the modified cash-basis of accounting requires management to make estimates and assumptions that affect the reported amounts of assets and disclosures of contingent liabilities at the date of the financial statements. Actual results could differ from those estimates.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

Note 2—Uninsured Cash Balances

The Corporation has interest-bearing deposits in one commercial bank. At June 30, 19X8, the Corporation's deposits exceeded Federal Deposit Insurance Corporation coverage by $823,908.

Note 3—Deposits

The Corporation has made deposits in the amount of $86,610 for equipment not placed in service at June 30, 19X7. The balance of $21,652 was paid upon delivery in August, 19X7.

Note 4—Note Receivable

The note receivable was received in connection with the sale of farm equipment to Fred Smythe dated April 27, 19X7. Weekly payments of $80 plus interest on the unpaid principal balance are to be received until April 28, 19X9, at which time the uncollected principal balance of $38,328 is due in full. The note bears interest at the prevailing prime rate and is secured by farm equipment whose estimated fair value was approximately $350,000 at June 30, 19X8.

Note 5—Employee Loans Receivable

The Company extended loans to two employees in 19X7 and to one employee in 19X8. The loans outstanding as of June 30, 19X7 were repaid on March 31, 19X8 and May 30, 19X8, respectively. The loan outstanding as of June 30, 19X8 is due on January 31, 19X9 and bears interest at the prevailing prime rate.

Note 6—Note Receivable—Ken Fisher

The note receivable represents an unsecured promissory note from Ken Fisher, a relative of William Fisher (stockholder), dated December 31, 19X7. Weekly payments of $400 plus interest are to be received through December 31, 19X8 at which time the uncollected principal balance of $26,714 is due in full. The note bears interest at the prevailing prime rate.

Note 7—Investments

The Corporation owned 16,000 shares of stock in Sunshine, Inc., a small, privately owned entity. It is not practicable to estimate the fair value of the Corporation's investment in Sunshine, Inc. as of June 30, 19X7 because of lack of quoted market prices and the inability to estimate fair value without incurring excessive costs.

Sunshine, Inc. filed for protection from creditors under Chapter 11 of the Federal Bankruptcy Code in September 19X7. A final hearing was held on October 1, 19X7, and the plan was confirmed and a final decree issued. No distributions were made to unsecured creditors or stockholders. As of June 30, 19X8, the stock has no value and has been written off by the Corporation.

Note 8—Treasury Stock

On June 1, 1990, Fisher Farms, Inc. distributed 25% of the fair market value of all assets owned by Ken Fisher in exchange for his 200 shares of stock in the Corporation. The exchange was a tax-free spin-off under Section 355 of the Internal Revenue Code.

Note 9—Custom Farming Costs

The Corporation receives custom farming services from Hope Harvesting, Inc. (Hope). The Corporation and Hope have common stockholders. During the years ended June 30, 19X8 and 19X7, the Corporation paid Hope $9,042,526 and $8,796,410 for these services.

Note 10—Rent—Land

The Corporation grows crops on various tracts of land that are leased under seasonal and one-year operating leases expiring in May and June, 19X9. Future minimum rental payments required under the above operating leases are $325,500 in 19X9.

Note 11—Contingent Liability

Fisher Farms, Inc. has guaranteed payment on a $3,900,000 mortgage note of the three stockholders, William Fisher, William Banks and Robert Fisher. The mortgage is secured by land owned by the three stockholders and is due November 30, 20XX with interest charged at 1/2% above prime. One of the stipulations in the note is that Fisher Farms, Inc. will not create any liens or other encumbrances other than those that currently exist on the Corporation's real or personal property. In addition to the mortgage note, the stockholders and their respective spouses have a line of credit from CountryBank in the amount of $4,500,000 each. This line of credit is guaranteed by the Corporation. The line of credit bears interest at the prime rate and matures on October 3, 19X8.

Outstanding balances:	19X8	19X7
Mortgage note	$ 3,040,000	$ 3,800,000
Line of credit	8,700,000	3,000,000

In June 19X8, the three stockholders informed the Company that their personal assets were insufficient to fully repay their lines of credit when the amount becomes due. Although the stockholders are now directing substantial effort toward restructuring the terms or extending the due date of the lines of credit, it is at least reasonably possible that the stockholders will be required to repay their lines of credit on their scheduled maturity dates, and they will not be able to. If so, the Company will become responsible for repayment of at least a portion of those debts. No amount has been reported in the Company's financial statements pending the outcome of the shareholders' efforts.

Note 12—Major Customers

Approximately 45 percent of the company's revenues in both 19X8 and 19X7 were provided by two customers.

SUPPLEMENTARY INFORMATION

Fisher Farms, Inc.

Schedules of Operating Expenses—Cash Basis
Years Ended June 30, 19X8 and 19X7

	19X8	19X7
Advertising	$ 28,994	$ 5,200
Consultant fees	770	9,472
Contributions	11,840	3,716
Contributions—political	1,000	9,380
Custom farming costs	9,042,526	8,796,410
Data processing—software services	1,150	792
Depreciation	627,388	806,536
Dues and subscriptions	110,550	65,664
Employee relations and expense	68,888	69,970
Equipment rental	115,300	10,332
Farming supplies and maintenance	2,694,600	2,027,126
Fertilizers and chemicals	7,838,950	6,697,098
Field workers' facilities	90,260	102,634
Fuel and oil	708,550	765,004
Freight and hauling	111,768	—
Insurance	1,733,696	1,827,490
Insurance—officers life	7,950	30,278
Interest expense	—	10
ITC reduction basis recovery	458	—
Labor camp appliances	9,298	5,204
Machine hire/land preparation	380,142	353,390
Management fees	24,176	24,000
Miscellaneous	11,394	29,472
Office expense	89,094	48,450
Packing supplies	2,929,708	2,624,216
Payroll	5,180,600	5,336,196
Payroll—officers	400,072	380,764
Penalties	68	78
Permits and licenses	46,022	35,736
Plants and seeds	2,849,760	2,845,590
Produce cooling and drying	20,774	4,370
Produce shipping	202,520	171,548
Professional fees	167,204	180,026
Rent—land	1,853,846	1,251,740
Repairs	2,247,178	2,250,892
Road expenses – drivers and tolls	24,496	19,004
Safety equipment and training	38,030	50,632
Security costs	3,292	1,346
Taxes	800,226	795,040
Telephone	200,626	226,560
Travel	4,016	896
Truck allowances—employees	31,776	38,400
Uncollectible advances	—	15,530
Uniforms	2,300	2,182
Utilities	503,642	571,784
Total	$41,283,040	$38,422,016

See accountant's review report.

ALEXANDER & AMES LIMITED PARTNERSHIP
FINANCIAL STATEMENTS
AS OF AND FOR THE YEAR ENDED
DECEMBER 31, 19X8

Author's Note. The following statements of a real estate limited partnership have been prepared on the tax-basis of accounting. These statements illustrate the following.

- *The presentation of the financial statements essentially conforms to a GAAP presentation for a real estate entity. For example, the assets and liabilities are unclassified, with the property and related mortgage debt being listed first in the presentation.*

- *The entity's basis of accounting includes a departure from the tax-basis of accounting. As described in the notes, the entity operates a racquet and swim club and it defers the recognition of revenue from members until that revenue is earned. Under the tax rules, that revenue would be recognized when received. Additionally, the entity uses the allowance method to account for bad debts, rather than the specific write-off method required by the IRC. The preparers of the financial statements believed these modifications were necessary to prevent the financial statements from being misleading. See chapter 2 of this publication for a further discussion of situations where it may be appropriate to depart from the stated basis of accounting. These departures from the basis of accounting result in an explanatory paragraph being added to the accountant's report.*

- *The Statement of Revenues and Expenses uses the caption "Revenues in excess of expenses" to describe what a GAAP financial statement would describe as "Net income." There is no requirement that prohibits the use of "Net income" or other GAAP captions <u>within</u> the financial statements. In this situation, the financial statement preparers have chosen the term because they believed it to be more descriptive.*

- *The financial statements include a Statement of Cash Flows, which (as discussed in chapter 3 of this publication) is not required for OCBOA financial statements. However, in this case, the financial statements include a single year only, thus it would be difficult for financial statement users to obtain accurately the information on operating, investing and financing activities presented in a statement of cash flows.*

In reading the notes to these financial statements, you may wish to take note of the following.

- *GAAP requires entities to disclose long-term debt maturities for the five years after the balance sheet date. The scheduled principal repayments for this entity are fairly constant for the next five years, so this information has been presented in narrative format.*

Independent Accountant's Review Report

The Partners
Alexander & Ames Limited Partnership

We have reviewed the accompanying statements of assets, liabilities and partners' capital—income tax-basis of Alexander & Ames Limited Partnership at December 31, 19X8 and the related statements of revenue and expenses—income tax-basis, partners' capital—income tax-basis, and cash flows—income tax-basis for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All the information included in these financial statements is the representation of the Partnership's management.

A review consists principally of inquiries of Partnership personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, with the exception of the matter described in the following paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the income tax-basis of accounting.

The Partnership's financial statements have been modified to defer recognition of unearned dues and to provide an allowance for doubtful accounts which should be recognized in the accompanying statement of revenues and expenses to conform with the basis of accounting used in preparing the Partnership's income tax return. If the effects of these modifications were included, partners' capital would be increased by approximately $160,000 as of December 31, 19X8 and revenues in excess of expenses would be increased by approximately $40,000 in 19X8.

[Signature of Firm]

[City and State]

[Date]

Alexander & Ames Limited Partnership

Statements of Assets, Liabilities and Partners' Capital—Income Tax Basis
December 31, 19X8

Assets	
Property and equipment	$ 11,864,666
Less accumulated depreciation	(2,810,112)
	9,054,554
Cash	450,944
Accounts receivable, less allowance for doubtful accounts of $49,360	451,194
Inventory	311,214
Prepaid expenses and other assets	24,046
Financing fees, less accumulated amortization of $57,096	259,124
Syndication costs	312,166
	$ 10,863,242
Liabilities and Partners' Capital	
Debt	$ 7,566,966
Accounts payable	276,502
Accrued payroll and related costs	117,792
Other accrued expenses	23,998
Unearned dues	369,586
Total liabilities	8,354,844
Partners' capital	2,508,398
	$ 10,863,242

See accompanying notes and accountant's review report.

Alexander & Ames Limited Partnership

Statement of Revenues and Expenses—Income Tax Basis

For the Year Ended December 31, 19X8

Revenues	
Membership dues	$ 3,970,334
Initiation fees	389,638
Tennis court fees and lessons	1,103,224
Other income	726,936
Sports shop and café, less cost of sales of $701,800	517,940
Total revenues	6,708,072
Expenses	
Management fee	50,700
Maintenance and operating	504,448
Utilities	391,460
Advertising and promotions	191,088
Payroll and related costs	2,774,706
Insurance	136,984
Administrative	212,028
Real estate taxes	351,246
Provision for doubtful accounts	34,878
Total expenses	4,647,538
Net operating income	2,060,534
Partnership expenses	(9,572)
Interest expense	(765,476)
Depreciation and amortization	(610,094)
Loss on sale of equipment	(4,240)
Revenues in excess of expenses	$ 671,152

See accompanying notes to financial statements.

Alexander & Ames Limited Partnership

Statement of Partners' Capital—
Income Tax Basis
For the Year Ended December 31, 19X8

	Limited Partners	Special Limited Partner	General Partner	Partners' Capital
Balance, December 31, 19X7	$ 1,017,392	$ 1,256,710	$ (69,276)	$ 2,204,826
Cash distributions	(238,924)	(55,138)	(73,518)	(367,580)
Revenues in excess of expenses	436,254	100,674	134,224	671,152
Balance, December 31, 19X8	$ 1,214,722	$ 1,302,246	$ (8,570)	$ 2,508,398

See accompanying notes and accountant's review report.

Alexander & Ames Limited Partnership

Statement of Cash Flows—
Income Tax Basis
For the Year Ended December 31, 19X8

Increase (Decrease) in Cash

Cash flows from operating activities	
Revenues in excess of expenses	$ 671,152
Adjustments to reconcile revenues in excess of expenses to cash flows from operating activities	
Depreciation and amortization	610,094
Loss on sale of equipment	4,240
(Increase) decrease in:	
Accounts receivable	(23,494)
Inventory	(102,916)
Prepaid expenses	1,472
Accounts payable and accrued expenses	74,992
Unearned dues	32,874
Net cash flows from operating activities	1,268,414
Cash flows used in investing activities	
Acquisition of equipment	(277,138)
Proceeds from sale of equipment	620
Net cash flows used in investing activities	(276,518)
Cash flows used in financing activities	
Repayment of debt	(473,574)
Cash distributions to partners	(367,580)
Net cash flows used in financing activities	(841,154)
Increase in cash	150,742
Cash at beginning of year	300,202
Cash at end of year	$ 450,944
Supplemental disclosures of cash flow information:	
Cash paid during the year for interest	$ 774,170

See accompanying notes and accountant's review report.

Alexander & Ames Limited Partnership

Notes to Financial Statements

For the Year Ended December 31, 19X8

Note 1—Nature of Operations and Partnership Organization

Nature of Operations

The Partnership owns and operates a racquet and swim club (the "Club") located in Minnesota. The Club has approximately 3,000 members at December 31, 19X8. The Club extends credit to members for the payment of dues and other charges.

The Partnership, formed in 19W5, is a limited partnership in accordance with the provisions of the Uniform Partnership Act as in effect in the State of Minnesota.

The General Partner of the Partnership is John Alexander.

Profit and Loss Allocations

Prior to December 1, 19X2 profits and losses from annual operations were allocated 99% to the Limited Partners and 1% to the General Partner.

Subsequent to November 30, 19X2 and until the Class A Limited Partners have received distributions of net cash flow equal to their Preferred Return, profits and losses from annual operations are allocated 65% to the Class A Limited Partners, 15% to the Special Limited Partner and 20% to the General Partner.

After the Class A Limited Partners have received cumulative distributions of net cash flow equal to their Preferred Return, profits and losses from annual operations will be allocated 45% to the Class A Limited Partners, 15% to the Special Limited Partner and 40% to the General Partner.

Net Cash Flow Allocation From Operations

Subsequent to November 30, 19X2, net cash flow is allocated 65% to the Class A Limited Partners, 15% to the Special Limited Partner and 20% to the General Partner until such time as the Class A Limited Partners have received cumulative distributions equal to their Preferred Return.

The balance of any net cash flow will be distributed 45% to the Class A Limited Partners, 15% to the Special Limited Partner and 40% to the General Partner.

Preferred Return

The Preferred Return means a 9% per annum cumulative noncompounded return on the Adjusted Capital Contribution of the Class A Limited Partners. The Adjusted Capital Contribution means the Original Capital Contributions are reduced only by distribution from the net proceeds of sale or refinancing.

Note 2—Summary of Significant Accounting Policies

Accounting Method

The Partnership's financial statements are prepared on the accounting basis used for federal income tax purposes. The Partnership uses the Accelerated Cost Recovery System (ACRS) and Modified Accelerated Cost Recovery System (MACRS) in depreciating its property. Under ACRS and MACRS, depreciation is determined over periods of time that are shorter than those used under generally accepted accounting principles. Additionally, the income tax methods used to capitalize and amortize amortizable assets differ from those used under generally accepted accounting principles.

The income tax-basis financial statements have been modified for the following items: 1) income tax regulations require unearned dues to be recognized in income during the period the dues are received; the financial statements defer the recognition of dues until the period they are earned; 2) the financial statements include an allowance for doubtful accounts; income tax regulations do not allow for such an account.

Syndication costs are carried as an asset of the Partnership and are not amortized. Under generally accepted accounting principles these costs would be deducted from partners' capital.

Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the amounts reported on the financial statements and accompanying notes. Actual results could differ from these estimates.

Concentration of Credit Risk

The Partnership places its cash with one banking institution. At times the amount on deposit exceeds the insured limit of the institution and exposes the Partnership to a collection risk.

Allowance for Doubtful Accounts

An allowance for doubtful accounts has been established based upon management's estimate of uncollectible accounts.

Inventories

Inventories, which consist of merchandise for sale in the sports shop, food and beverages, are stated at the lower of cost (first-in, first-out method) or market.

Membership Dues and Initiation Fees

Membership dues are billed in advance and recorded in accounts receivable and unearned dues. The dues are recognized as revenue in the month earned. Initiation fees are recorded as revenue in the period when the fee is collected.

Property and Equipment

Property and equipment are carried at cost. Depreciation is computed using income tax methods. The cost of maintenance and repairs is charged to income as incurred; significant renewals or betterments are capitalized.

Organization Costs

Organization costs are amortized over 60 months using the straight-line method.

Financing Fees

Financing fees are amortized over the term of the related debt using the straight-line method. During 19X2 financing fees related to retired debt were written off. The financing fees related to new debt were capitalized.

Start-Up Costs

Start-up costs are amortized over 60 months using the straight-line method.

Income Taxes

No provision for income taxes has been made, as the liability for such taxes is that of the Partners rather than that of the Partnership.

Note 3—Property and Equipment

Property and equipment at December 31, 19X8 consisted of the following:

		Depreciation Lives—Years
Land	$ 975,720	—
Building	9,320,050	7–40
Tenant improvements	1,568,896	5–7
	$ 11,864,666	

Depreciation expense was $512,836 during 19X8.

Note 4—Debt

At December 31, 19X8, debt consisted of the following:

Mortgage loan payable in monthly payments of $73,124, including interest at 9.375%, through January 200Y when the interest rate changes to 3.5% above the Three-Year Treasury Base Rate. Beginning February 1, 200Y monthly payments will be adjusted to reflect the new interest rate; the payments will be based upon a 15-year term. The remaining principal is due January 1, 200Z. The mortgage is secured by property, equipment and a personal guaranty.	$ 6,778,186
10% unsecured note payable to the Special Limited Partners due in monthly installments of $16,546, including principal and interest, through February 1, 200Z when the unpaid balance is due.	788,780
	$ 7,566,966

Scheduled principal payments under these loans is approximately $380,000 per year until February 1, 200Y when payment terms will be adjusted as described above.

Note 5—Amendment of the Partnership Agreement

The Partnership Agreement was amended effective November 30, 19X7. The primary purpose of the amendment was to create a new class of limited partner (the Special Limited Partner) and to change the allocations of profits, losses and cash distributions.

Effective November 30, 19X7, John Ames surrendered his 67 limited partnership units in exchange for $1,450,000 and a 15% special limited partnership interest. Additionally, as part of this exchange $200,000 was paid down on the note payable to the Special Limited Partner, the interest rate on this note was reduced to 10% from 12%, and the term of the note was shortened.

Note 6—Transactions With Affiliates

At December 31, 19X8, the Partnership owed Partners or affiliated entities $788,780.

During 19X8 a management fee of $50,700 was paid to a Partner.

RIGGS & RIGGS REALTY
FINANCIAL STATEMENTS
YEARS ENDED
DECEMBER 31, 19X8 AND 19X7

Author's Note. The following statements of a real estate partnership have been prepared on the income tax-basis of accounting. These statements illustrate the following points.

- *The presentation of the financial statements essentially conforms to a GAAP presentation of a real estate entity. For example, the assets and liabilities are unclassified, with the property and related mortgage debt being listed first in the presentation. A note at the bottom of each page directs the user to the accompanying notes and accountant's report, which is common for OCBOA financial statements.*

- *As discussed in chapter 3 of this publication, the consolidation accounting for tax-basis financial statements follows the tax rules. Thus, if an entity files a consolidated tax return, its tax-basis financial statements should be on a consolidated basis, and vice versa. While GAAP acknowledges that some situations require <u>combined</u> financial statements, the notion of a combined financial statement does not exist in the tax rules.*

  The following financial statements are the financial statements of Riggs & Riggs Realty only. The preparers of these financial statements found it necessary to state that, under GAAP, stand-alone financial statements for Riggs & Riggs Realty would not be issued, but rather, they would be combined with other entities under common control. The accountant's report includes an explanatory paragraph to highlight this fact.

- *As described in Notes 2 and 6 to the financial statements, the entity is obligated under notes payable to its partners. Under the tax rules, interest on these loans is not deductible until paid. For financial reporting purposes, the entity has recognized an accrual for unpaid interest on notes payable to partners, as described in Note 6. The offsetting debit has been reported as an asset, described as "Deferred interest." The advantage to this presentation method is that the statement of operations is a truer reflection of the tax return.*

  Alternatively, the entity might have chosen to report changes in the accrued interest balance as a nondeductible expense in the statement of operations. The advantage to this practice is that it more accurately reflects the results of the entity during the period, assuming that the total amount of the deferred interest eventually will be paid. In practice, both methods of reporting nondeductible interest to partners are used.

In reading the notes to these financial statements, you may wish to take note of the following.

- *The Summary of Significant Accounting Policies includes a note describing that the accompanying financial statements do not include any related business entities under common control and that GAAP would require combined financial statements. This is a description of the situation that caused the accountants to add an explanatory paragraph to their report. The notes include a significant amount of related-party disclosures.*

- *The Use of Estimates disclosure has been expanded beyond the standard language typically found in most financial statements.*

- *Note 5 on accounts payable and accrued liabilities is not a required disclosure, but the financial statement users find the information meaningful.*

Independent Accountant's Report

To the Partners of
Riggs & Riggs Realty

We have compiled the accompanying balance sheets—federal income tax-basis of Riggs & Riggs Realty as of December 31, 19X8 and 19X7, and the related statements of operations and partners' deficit—federal income tax-basis and partners' deficit—federal income tax-basis for the years then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. These financial statements have been prepared on the federal income tax-basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting information in the form of financial statements that is the representation of the management of Riggs & Riggs Realty. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

These financial statements are the financial statements of Riggs & Riggs Realty only and do not include the accounts of other related business entities under common ownership or control, as described in Note 1.

[Signature of Firm]

[City and State]

[Date]

Riggs & Riggs Realty

Balance Sheets
(Federal Income Tax Basis)

December 31, 19X8 and 19X7

Assets	**19X8**	**19X7**
Investment in real estate, at cost, collateral for deed of trust notes payable (Notes 2 and 4)		
Land under development	$ 4,832,321	$ 3,089,753
Development and predevelopment costs	11,273,049	12,058,072
Land not under development	3,412,001	5,928,211
	19,517,371	21,076,036
Cash	84,517	90,275
Accounts receivable—other	2,262	1,136
Notes receivable from related parties (Note 3)	191,861	194,229
Subdivision bonds	502,325	244,200
Visitors Center		
Land	170,452	170,451
Building, net of accumulated depreciation of $51,224 in 19X8 and $42,643 in 19X7	189,076	197,657
Intangibles, net of accumulated amortization of $101,483 in 19X8 and $95,989 in 19X7	—	5,494
Deferred interest (Notes 2 and 6)	3,151,344	2,224,815
	4,291,837	3,128,257
Total assets	$ 23,809,208	$ 24,204,293
Liabilities and Partners' Deficit		
Deed of trust notes payable, collateralized by investment in real estate (Note 4)	$ 18,588,053	$ 19,371,436
Accounts payable and accruals (Note 5)	278,483	190,037
Payables to related parties (Note 6)	16,712,108	15,545,648
Deposits from purchasers	150,500	92,500
Total liabilities	35,729,144	35,199,621
Partners' deficit	(11,919,936)	(10,995,328)
Total liabilities and partners' deficit	$ 23,809,208	$ 24,204,293

See accompanying notes and accountant's compilation report.

Riggs & Riggs Realty

Statements of Operations and Partners' Deficit
(Federal Income Tax Basis)

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Real estate revenue	$ 8,683,118	$ 6,034,500
Cost of real estate revenue	7,516,252	4,995,898
Gross profit	1,166,866	1,038,602
Selling, general and administrative expenses		
Management fee	230,000	240,000
Real estate taxes	79,431	88,347
Bad debts	—	6,234
Maintenance	91,033	81,519
Media advertising	300,700	161,933
Marketing	68,918	96,697
Contributions	—	750
Professional fees	28,531	22,324
Depreciation and amortization	14,074	29,793
Utilities	20,538	13,176
Community association dues	7,006	6,101
Business license	5,494	3,500
Other	21,910	7,849
	867,635	758,223
Operating income	299,231	280,379
Interest expense, net of interest income of $18,244 in 19X8 and $12,168 in 19X7	(1,254,756)	(1,604,353)
Other income	30,917	13,668
Net loss	(924,608)	(1,310,306)
Partners' deficit, beginning of year	(10,995,328)	(9,685,022)
Partners' deficit, end of year	$(11,919,936)	$(10,995,328)

See accompanying notes and accountant's compilation report.

Riggs & Riggs Realty

Statements of Partners' Deficit
(Federal Income Tax Basis)

Years Ended December 31, 19X8 and 19X7

	Riggs Partnership	Roberts Partnership	Alan Rowe	Total
Percentage interest	50%	37.5%	12.5%	100%
Partners' deficit, December 31, 19X6	$(4,842,511)	$(3,631,883)	$(1,210,628)	$ (9,685,022)
Net loss	(655,153)	(491,365)	(163,788)	(1,310,306)
Partners' deficit, December 31, 19X7	(5,497,664)	(4,123,248)	(1,374,416)	(10,995,328)
Net loss	(462,304)	(346,728)	(115,576)	(924,608)
Partners' deficit, December 31, 19X8	$(5,959,968)	$(4,469,976)	$(1,489,992)	$(11,919,936)

See accompanying notes and accountant's compilation report.

Riggs & Riggs Realty

Notes to Financial Statements
(Federal Income Tax Basis)

Years Ended December 31, 19X8 and 19X7

Note 1—Summary of Significant Accounting Policies

Organization and Nature of Business

The Partnership was organized on March 27, 19W5 under the laws of the Commonwealth of Virginia for the purpose of acquisition, ownership, management, lease and ultimate disposition of real estate. The Partnership is engaged in real estate development in Virginia. Under the terms of the Partnership Agreement, the Partnership will terminate on December 31, 200Y, unless amended otherwise.

The Partnership is engaged primarily in the development and sale of residential and townhouse lots in the Charlottesville area. The significant accounting policies are summarized below.

Related Business Entities

The Partnership is related to other business entities through common ownership or control. These financial statements do not include any other related business entities that are under common ownership or in which the partners have a direct or indirect controlling financial interest. The financial effects of control of two or more business enterprises by common ownership are more appropriately reflected in combined financial statements presented in accordance with generally accepted accounting principles applicable to consolidations.

Basis of Accounting

The accompanying financial statements have been prepared on the federal income tax accrual basis of accounting. Revenue from real estate sales is primarily recognized when all conditions precedent to closing have been performed, which generally is at the time of settlement.

Land costs and real estate taxes are allocated to blocks within sections in land under development and land not under development based on the acreage in the block to the total acreage at the beginning of the year. Actual physical development has commenced on land under development but not on land not under development. Land under development is allocated to the cost of real estate revenue on a block-by-block basis using the relative sales value of the portion of the block sold during the year to the total estimated sales value of the block unsold at the beginning of the year.

Development and predevelopment costs also include development management fees, real estate taxes and interest (not including interest on notes payable to partners). Development costs are allocated to various blocks within sections in land under development based upon specific identification and the total acreage under development during the year. Development management fees are allocated to blocks in land under development based on costs incurred in the block to costs incurred during the year on all blocks. Development costs and development management fees are allocated to the cost of real estate revenue on a block-by-block basis using the relative sales value of the portion of the block sold during the year to the total estimated sales value of the block unsold at the beginning of the year. Development management fees charged as a period cost were based on management's estimates.

Interest costs incurred on land under development is first capitalized to the specific blocks within the section to which the loan relates. The balance of the interest, as required by the Internal Revenue Code, is capitalized to blocks in land under development based on the accumulated production expenditures of each block to the accumulated production expenditures of the remaining sold and unsold blocks under development. Accumulated production expenditures include land, development and predevelopment costs. Interest costs incurred on land not under development are expensed until actual physical development commences, at which time interest costs are capitalized. Interest and real estate tax costs on finished lots are expensed.

Selling, general and administrative expenses are charged to operations as incurred.

Investment in Real Estate

Investment in real estate is recorded at cost and includes land, land acquisition, development, interest on land under development and real estate tax costs.

Visitors Center

The Visitors Center building is recorded at cost and depreciated using the straight-line method over 31.5 years.

Intangibles

Permanent loan fees are amortized using the straight-line method over the five-year term of the related deed of trust note payable.

Deposits from Purchasers

Deposits received from prospective purchasers are applied at settlement as a portion of the down payment.

Income Taxes

No provision for income taxes has been made, as the liability for such taxes is that of the Partners rather than that of the Partnership.

Use of Estimates

The preparation of these financial statements requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and the accompanying notes. In addition, they affect the reported amounts of revenue and expense during the reported period, in particular, the allocation of land, development and predevelopment costs. Actual results could differ from these estimates and assumptions. Revision of estimates relating to cost allocations are accounted for in the period in which the revision becomes known and future periods.

Note 2—Investment in Real Estate

During 19X8, of the 556 single family and townhouse lots available for sale, 328 were sold and 180 were under contract. During 19X7, of the 521 single family and townhouse lots available 248 were sold and 262 were under contract.

Included in the real estate investment at December 31, 19X8, are capitalized interest of $1,296,648 and real estate taxes of $803,092 and at December 31, 19X7, are capitalized interest of $1,328,212 and real estate taxes of $783,332.

Interest cost incurred for the year ended December 31, 19X8 is $2,029,746, of which $756,745 was capitalized. Interest cost incurred for the year ended December 31, 19X7 is $1,889,690, of which $273,169 was capitalized. Interest on notes payable to partners was deferred in 19X8 and 19X7. See Note 6.

Note 3—Notes Receivable From Related Parties

Notes receivable from related parties are from related business entities and are unsecured, due on demand, and bear interest at the prime rate. At December 31, related party notes receivables are as follows:

	19X8	19X7
Notes receivable	$ 162,188	$ 158,250
Accrued interest	29,673	35,979
Totals	$ 191,861	$ 194,229

Note 4—Deed of Trust Notes Payable

The Partnership obtained financing from a commercial bank for the acquisition, development and sale of single family and townhouse lots. The maximum amount of the loan is $20,000,000 at any one time and $69,935,500 in the aggregate. Principal curtailments are due as lots are sold. In addition, principal curtailments of $66,875 are due December 31, 19X8, June 30, 19X9, and September 30, 19X9. The maximum amount of the loan is permanently reduced by the principal curtailments of $66,875 each and for the sale of nonresidential properties and multifamily lots. All principal and interest are due on September 30, 19X9. Interest is payable monthly at prime plus 3% to March 31, 19X9, and at prime plus 4% from April 1, 19X9 to September 30, 19X9. Extension fees of 1% of the maximum loan amount are payable by June 30, 19X8 and June 30, 19X9. During 19X8, the commercial bank sold the loan to an investor for approximately $17,000,000. The Partnership currently plans to negotiate with the holder of the deed of trust to extend the maturity date of the note.

Following is a summary of deed of trust notes outstanding at December 31:

	19X8	19X7
Deed of trust note payable (above)	$ 17,863,234	$ 18,638,310
Purchase money note payable, principal and interest at 12%, payable in monthly installments of $2,070, maturing June 1, 200Y	724,819	733,126
Totals	$ 18,588,053	$ 19,371,436

The following is a schedule, by years, of future amounts due on the notes, excluding interest:

Year Ending December 31,	
19X9	$ 18,456,684
20XX	9,500
20XY	10,750
20XZ	12,000
20YA	14,000
Thereafter	85,119
Totals	$ 18,588,053

Note 5—Accounts Payable and Accruals

Accounts payable and accruals at December 31 consist of the following:

	19X8	19X7
Accrued interest payable	$ 154,570	$ 145,177
Accounts payable—trade	123,913	12,263
Estimated costs to complete lots sold	—	32,597
Totals	$ 278,483	$ 190,037

Note 6—Payables to Related Parties

Payables to related parties are from partners and related business entities and, at December 31, consist of the following:

	19X8	19X7
Accounts payable, related business entity	$ 314,683	$ 224,762
Notes payable, related business entity Unsecured notes payable; interest payable annually on December 31, at the prime rate; principal and unpaid interest due on demand	4,376,680	4,376,680
Notes payable, partners Unsecured demand notes payable; interest at prime rate	8,869,401	8,719,391
Deferred interest	3,151,344	2,224,815
Total accounts and notes payable to related parties	$ 16,712,108	$ 15,545,648

Deferred interest on notes payable to partners is not deductible until paid.

Note 7—Related-Party Transactions

A related business entity provided subcontract land development services at costs of approximately $3,521,500 for the year ended December 31, 19X8, and $718,500 for the year ended December 31, 19X7. Development management services provided by a related business entity totaled approximately $600,000 for the year ended December 31, 19X8, and $650,000 for the year ended December 31, 19X7.

MILLER MEDICAL EQUIPMENT
FINANCIAL STATEMENTS
AND SUPPLEMENTAL INFORMATION
YEARS ENDED
DECEMBER 31, 19X8 AND 19X7

Author's Note. The following financial statements of an S Corporation have been prepared on the tax-basis of accounting. These financial statements illustrate the following points.

- *The financial statements include extensive supplementary schedules relating to expenses, which have been prepared on the same basis of accounting used to prepare the financial statements. The accountant's report has been modified accordingly.*

- *The Statement of Revenues, Expenses and Retained Earnings uses the caption "Excess of Revenues Over Expenses" to describe what a GAAP financial statement would describe as "Net income." There is no requirement that prohibits the use of "Net income" or other GAAP captions <u>within</u> the financial statements. In this situation, the financial statement preparers have chosen the term because they believed it to be more descriptive.*

- *The financial statements include a statement of cash flows, which is not required for OCBOA financial statements. Interpretation 14 of SAS No. 62 states that if a statement of cash flows is included in a set of OCBOA financial statements, it should either conform to the requirements of a GAAP presentation or communicate their substance. This presentation conforms to a GAAP presentation.*

When reading the notes to these financial statements, you may wish to take note of the following.

- *The company accounts for the impairment of long-lived assets according to the tax rules, which differ from GAAP, as described in Note 1. At December 31, 19X8, the company has plans to dispose of certain assets which, under GAAP, would require a writedown of these assets to fair value minus costs to sell. This situation has been described in Note 3.*

Independent Accountant's Report

To the Board of Directors and Stockholders of
Miller Medical Equipment

We have compiled the accompanying statements of assets, liabilities and stockholder's equity—federal income tax-basis of Miller Medical Equipment as of December 31, 19X8 and 19X7, and the related statements of revenues, expenses and retained earnings—federal income tax-basis and statements of cash flows—federal income tax-basis for the years then ended, together with the supplementary schedules of costs of sales and rentals, selling, delivery, retail, and general and administrative expenses—federal income tax-basis for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. These financial statements have been prepared on the federal income tax-basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting information in the form of financial statements that is the representation of the management of Miller Medical Equipment. We have not audited or reviewed the accompanying financial statements and supplemental schedules of costs of sale and rentals, selling, delivery, retail, and general and administrative expenses and, accordingly, do not express an opinion or any other form of assurance on them.

[Signature of Firm]

[City and State]

[Date]

Miller Medical Equipment

Statements of Assets, Liabilities and Stockholder's Equity—Income Tax Basis

December 31, 19X8 and 19X7

Assets	19X8	19X7
Current Assets		
Cash	$ 54,568	$ 7,596
Accounts receivable	3,460,346	1,741,070
Inventory	475,818	392,950
Other current assets	15,664	9,110
	4,006,396	2,150,726
Rental Equipment—net of accumulated depreciation of $2,013,724 and $1,567,110	2,306,998	1,227,432
Property and Equipment		
Vehicles	401,858	221,184
Computer equipment	259,158	181,000
Furniture and fixtures	164,978	140,770
Leasehold improvements	180,560	145,704
	1,006,554	668,658
Less accumulated depreciation	374,716	276,094
	631,838	412,564
Other Assets		
Deposits	17,300	16,620
Loan origination fees—net of accumulated amortization of $2,726 and $4,650	17,724	4,650
	35,024	21,270
	$ 6,980,256	$ 3,811,992

See accountant's compilation report and notes to financial statements.

Miller Medical Equipment

Statements of Assets, Liabilities and Stockholder's Equity—Income Tax Basis

December 31, 19X8 and 19X7

Liabilities and Stockholder's Equity	19X8	19X7
Current Liabilities		
Note payable—line of credit	$ 430,000	$ —
Current portion of long-term debt	469,220	268,206
Notes payable—vendors	432,692	—
Accounts payable—trade	631,428	744,652
Accrued salaries and wages	72,472	29,456
Accrued and withheld payroll taxes	61,474	39,080
Accrued taxes and other expenses	53,974	32,556
	2,151,260	1,113,950
Long-Term Debt—net of current portion	2,226,540	830,370
Stockholder's Equity		
Capital stock—no par value; 25,000 shares authorized; 1,000 issued and outstanding	8,182	8,182
Retained earnings	2,594,274	1,859,490
	2,602,456	1,867,672
	$ 6,980,256	$ 3,811,992

See accountant's compilation report and notes to financial statements.

Miller Medical Equipment

Statements of Revenues, Expenses and Retained Earnings—Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Revenues		
Equipment rentals	$ 7,275,534	$ 5,271,156
Home care sales	1,672,222	1,038,688
Retail sales	1,990,216	1,076,032
	10,937,972	7,385,876
Cost of Sales and Rentals	3,525,668	2,110,344
Gross Profit	7,412,304	5,275,532
Operating Expenses		
Selling	1,273,530	874,698
Delivery	1,012,602	730,108
Retail	717,550	587,630
General and administrative	3,465,298	2,570,074
	6,468,980	4,762,510
Revenue from Operations	943,324	513,022
Interest and Miscellaneous Income	7,048	1,160
Excess of Revenues Over Expenses	950,372	514,182
Retained Earnings—Beginning	1,859,490	1,511,424
Less distributions to stockholder	215,588	166,116
Retained Earnings—Ending	$ 2,594,274	$ 1,859,490

See accountant's compilation report and notes to financial statements.

Miller Medical Equipment

Statements of Cash Flows—Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Cash Flows from Operating Activities		
Excess of revenues over expenses	$ 950,372	$ 514,182
Adjustments to reconcile excess of revenues over expenses to net cash provided by operating activities:		
Depreciation and amortization	784,032	496,740
Loss on asset disposition	—	3,000
Interest	4,618	—
Changes in assets and liabilities:		
Accounts receivable	(1,039,276)	(406,776)
Inventory	87,132	(216,662)
Other current assets	(6,554)	(330)
Other assets	(680)	2,092
Accounts payable	(113,228)	275,212
Accrued expenses	86,832	71,778
	753,248	739,236
Cash Flows from Investing Activities		
Acquisition of property and equipment	(791,008)	(741,760)
Acquisition of home medical company assets	(1,440,000)	—
	(2,231,008)	(741,760)
Cash Flows from Financing Activities		
Proceeds from borrowing	2,348,786	500,240
Payments on debt	(339,402)	(345,622)
Payments on vendor notes	(269,064)	—
Distributions to stockholder	(215,588)	(166,116)
	1,524,732	(11,498)
Increase (decrease) in Cash	46,972	(14,022)
Cash—Beginning	7,596	21,618
Cash—Ending	$ 54,568	$ 7,596

See accountant's compilation report and notes to financial statements.

Miller Medical Equipment

Statements of Cash Flows—Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for interest	$ 173,152	$ 91,908
Schedule of noncash investing and financing transactions:		
Long-term debt refinanced	$ 855,978	
Vendor notes payable incurred for rental inventory	$ 694,490	

See accountant's review report and notes to financial statements.

Miller Medical Equipment

Notes to Financial Statements

Years Ended December 31, 19X8 and 19X7

Note 1—Nature of Business and Summary of Significant Accounting Policies

Nature of Business

The Company, formerly doing business as Miller Brothers, sells and rents oxygen and home medical equipment to patients covered by Medicare or other insurance. The Company also has three retail outlets, which it opened during 19X8 and 19X7. The Company serves western Pennsylvania, eastern Ohio, and northern West Virginia.

Basis of Accounting

The Company prepares its financial statements on the accrual basis of accounting used for income tax reporting. This basis differs from generally accepted accounting principles primarily because—

- Depreciation is calculated using the statutory accelerated cost recovery periods instead of useful lives
- Accounts receivable are written off when deemed uncollectible, with no allowance for doubtful accounts reflected in the financial statements.
- Losses on disposition of long-lived assets are recognized when the asset is sold rather than the point at which management decides to dispose of the asset.

Use of Estimates

The preparation of financial statements in accordance with the tax-basis of accounting requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates and assumptions.

Inventory

Inventory is valued at the lower of cost or market using the first-in, first-out method of valuation.

Depreciation

Rental equipment and property and equipment are stated at cost. Depreciation is computed using the accelerated cost recovery and modified cost recovery methods allowable under the Internal Revenue Code. The recovery periods being used are 5 and 7 years for furniture, fixtures and equipment and 31.5 years for leasehold improvements.

Loan Origination Fees

Loan origination fees associated with the acquisition of the bank note are amortized using the straight-line method over the term of the note agreement.

Retirement Plans

Profit sharing costs are funded as accrued.

Income Taxes

Effective January 1, 19X1, the Company elected to be taxed as an S Corporation under Section 1362(a) of the Internal Revenue Code. The effect of this election is that taxable results of operations and tax credits generated are reportable on the individual income tax return of the stockholder. Accordingly, no provision for corporate income taxes has been made.

Note 2—Business Acquisition

Effective May 17, 19X8, the Company acquired certain assets of Medical Products, Inc., a home medical equipment company. The assets acquired were:

Accounts receivable	$ 680,000
Rental equipment	584,000
Inventory	170,000
Vehicles	6,000
	$ 1,440,000

The purchase was financed with a bank term note, described in Note 3.

Note 3—Rental Equipment Held for Disposal

In November 19X8 the Company decided to sell certain of its rental equipment due to obsolescence and redundancy with assets acquired from Medical Products, Inc. The estimated fair value of this equipment is approximately $175,000. At December 31, 19X8, the carrying amount of the equipment (cost less accumulated depreciation) was approximately $235,000. In accordance with the tax rules, any loss on the disposition of this equipment will be recognized when the equipment is sold.

Note 4—Notes Payable and Long-Term Debt

The Company has an $800,000 line of credit with a bank, payable on demand, with interest payable monthly at prime plus .75%. The line is collateralized by cash, accounts receivable, inventory and equipment. The balance outstanding at December 31, 19X8 was $430,000. The prime rate at December 31, 19X8 was 8%.

Long-term debt consists of the following at December 31:

	19X8	19X7
Bank term note, payable in monthly principal installments of $31,110, with interest payable monthly at prime plus 1.25% due June, 19X7, collateralized by cash, accounts receivable, inventory, equipment and the personal guarantee of the sole stockholder.	$ 2,426,722	$ —
Bank note, payable in monthly principal installments of $15,500, with interest payable monthly at prime plus 1%, due April, 20XX, collateralized by cash, accounts receivable, inventory and equipment. This debt was refinanced in 19X8.	—	849,500
Capitalized leases on equipment, payable in aggregate monthly installments of $4,410, with interest ranging from 17.5% to 24%, due on various dates through March, 19X8, collateralized by equipment with a cost of $309,182 and a net book value of $108,838 at December 31, 19X7	269,038	249,076
	2,695,760	1,098,576
Less current portion	469,220	268,206
	$ 2,226,540	$ 830,370

Maturities of long-term debt are as follows:

19X9	$ 461,430
20XX	426,356
20XY	405,400
20XZ	933,354
	$ 2,226,540

Total interest expense for the years ended December 31, 19X8 and 19X7 was $173,152 and $91,908, respectively.

All bank debt is secured by the personal guarantee of the stockholder and assignment of a $4,000,000 life insurance policy on the stockholder. The Company is also subject to the following covenants with respect to all bank notes and lines of credit: a minimum current ratio of 1.5:1, a minimum tangible net worth of $2,000,000, a minimum cash flow to debt service of 1.20:1 measured quarterly based on the previous four quarters, and a maximum debt to tangible net worth ratio of 1.75:1.

Note 5—Notes Payable—Vendors

The notes payable to vendors are short-term financing arrangements for the purchase of rental equipment inventory. They are payable in aggregate monthly installments of $55,122, which includes interest at rates of up to 20%. The notes are due at various dates through October, 19X4 and are collateralized by the equipment. Interest expense for 19X8 was $14,518.

Note 6—Retirement Plans

The Company maintains a qualified profit-sharing plan covering all eligible employees. The plan includes a deferred arrangement under section 401(k) of the Internal Revenue Code. The elective contributions to the 401(k) portion of the plan are funded by salary reductions of the participants. Company contributions to the plan are discretionary up to a maximum of 15% of annual wages paid and accrued for the year, and are generally based on net income.

Contributions for the years ended December 31, 19X8 and 19X7 were:

	19X8	19X7
Company	$ 104,256	$ 61,430
Employees	76,578	68,320
Total	$ 180,834	$ 129,750

Note 7—Commitments and Related-Party Transactions

The Company leases four offices and warehouse facilities in Pennsylvania and West Virginia. The leases have terms ranging from one to six years and expire at various dates through August, 19X8. Total rental expense for the years ended December 31, 19X8 and 19X7 was $367,964 and $328,460, respectively.

Included in the above, are leases for two office facilities with the sole stockholder. The rentals on these leases for each of the years ended December 31, 19X8 and 19X7 were $169,440.

Future minimum rental payments are as follows:

	Stockholder	Other	Total
19X9	$ 150,240	$ 249,592	$ 399,832
20XX	150,240	246,792	397,032
20XY	150,240	209,720	359,960
20XZ	150,240	64,800	215,040
20YA	—	43,200	43,200
	$ 600,960	$ 814,104	$ 1,415,064

Note 8—Operating Leases

The Company has entered into various vehicle and equipment leases payable in aggregate monthly payments of $12,270, expiring on various dates through November, 20XY. Total lease expense for the years ended December 31, 19X8 and 19X7 was $147,078 and $139,528, respectively.

Future minimum lease payments are as follows:

19X9	$ 132,540
20XX	91,830
20XY	28,396
	$ 252,766

Note 9—Subsequent Event

On January 4, 19X4, the Company purchased certain assets of Home-Med, Inc., an Ohio corporation, for $850,000. The assets purchased consist of accounts receivable, fixed assets, vehicles, supplies, furniture and fixtures, other assets, and a one-year covenant not to compete.

The purchase price was financed with a term note for $850,000, which is secured by the guarantee of the sole stockholder.

Miller Medical Equipment

Schedules of Costs of Sales and Rentals, Selling, Delivery and Retail Expenses— Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Costs of Sales and Rentals		
Inventory—beginning	$ 392,950	$ 176,286
Purchases	2,350,778	1,572,234
Supplies	564,416	277,050
Depreciation	623,694	408,246
Equipment rental	13,246	31,396
Freight	56,402	38,082
	4,001,486	2,503,294
Inventory—ending	475,818	392,950
	$ 3,525,668	$ 2,110,344
Selling Expenses		
Payroll, payroll taxes, and employee benefits	$ 659,544	$ 511,740
Bad debts	329,600	169,654
Commissions	108,236	30,126
Vehicle expense	79,946	72,518
Advertising	59,798	61,982
Entertainment and travel	36,406	28,678
	$ 1,273,530	$ 874,698
Delivery Expenses		
Payroll, payroll taxes, and employee benefits	$ 712,492	$ 533,818
Truck expense	212,854	164,166
Depreciation	67,140	17,662
Freight	20,116	14,462
	$ 1,012,602	$ 730,108
Retail Expenses		
Payroll, payroll taxes, and employee benefits	$ 360,184	$ 299,996
Rent	137,690	115,062
Advertising	82,698	82,074
Commissions	34,644	9,514
Store expense	27,892	32,064
Entertainment and travel	23,530	12,646
Telephone	23,222	16,992
Utilities	16,156	8,686
Vehicle expense	11,534	10,596
	$ 717,550	$ 587,630

Miller Medical Equipment

Schedules of General and Administrative Expenses—
Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
General and Administrative Expenses		
Salaries and wages	$ 1,325,658	$ 1,130,038
Telephone	249,808	166,564
Rent	230,274	213,398
Office expense	212,198	162,804
Commissions	180,486	10,310
Interest	173,152	91,908
Payroll taxes	112,942	82,186
Retirement plan contribution	104,256	61,430
Insurance	102,904	88,486
Outside services	94,104	69,086
Employee benefits	91,752	66,956
Depreciation and amortization	90,334	66,002
Travel and entertainment	84,600	71,272
Other taxes	84,298	62,984
Professional fees	82,464	31,086
Utilities	48,782	44,486
Vehicle expense	40,488	20,638
Dues and subscriptions	35,222	26,376
Postage	34,134	24,338
Building expense	22,774	19,224
Data processing costs	21,294	19,618
Meetings and seminars	14,338	13,926
Leased equipment	13,666	13,950
Miscellaneous	9,408	5,144
Contributions	5,962	7,864
	$ 3,465,298	$ 2,570,074

MAXON CONTRACTORS, INC.
FINANCIAL STATEMENTS
YEARS ENDED
DECEMBER 31, 19X8 AND 19X7

Author's Note. The following financial statements of an S Corporation have been prepared on the tax-basis of accounting. The entity is a construction contractor that uses the completed-contract method for recognizing revenue. These financial statements illustrate the following points.

- *The presentation of the financial statements essentially conforms to a GAAP presentation for a construction contractor.*

- *The financial statements include a statement of cash flows, which is not required for OCBOA financial statements. Interpretation 14 of SAS No. 62 states that if a statement of cash flows is included in a set of OCBOA financial statements, it should either conform to the requirements of a GAAP presentation or communicate their substance. This presentation conforms to a GAAP presentation; information about cash payments for interest is included in the notes.*

In reading the notes to these financial statements, you may wish to take note of the following.

- *Information about contract receivables (Note 2) billings in excess of costs on uncompleted contracts (Note 6) and backlog (Note 7) are disclosures typically made in the financial statements of construction contractors. However, the aging summary of contract receivables is not usually disclosed. In this situation, the information must be relevant to the needs of the financial statement users.*

- *The information on accounts payable and accruals is not required but has been included because the users of the financial statements find it meaningful.*

- *GAAP requires a summary of future minimum lease payments, which usually is presented in a schedule. Because the entity's lease commitments are not complex, this information has been summarized in narrative form, which is acceptable for OCBOA financial statements.*

Independent Accountant's Report

To the Board of Directors and Stockholders
Maxon Contractors, Inc.

We have compiled the accompanying balance sheets—federal income tax-basis of Maxon Contractors, Inc. as of December 31, 19X8 and 19X7, and the related statements of operations and retained earnings—federal income tax-basis and of cash flows—federal income tax-basis for the years then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information and disclosures included in these financial statements are the representations of the owners of Maxon Contractors, Inc.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit of financial statements in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying December 31, 19X8 and 19X7 financial statements in order for them to be in conformity with the federal income tax-basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

[Signature of Firm]

[City and State]

[Date]

Maxon Contractors, Inc.

Statements of Assets, Liabilities and Equity
Federal Income Tax Basis

December 31, 19X8 and 19X7

Assets	19X8	19X7
Current Assets		
Cash and cash equivalents	$ 3,078,966	$ 3,608,930
Accounts receivable—contract (Note 2)	2,409,554	1,422,268
Advances to officers	7,812	—
Inventory	287,714	196,200
Total current assets	5,784,046	5,227,398
Property and Equipment		
Machinery and equipment	1,694,980	1,710,828
Transportation equipment	384,790	395,042
Office furniture and equipment	162,454	163,034
Leasehold improvements	363,798	363,798
Total cost	2,606,022	2,632,702
Accumulated depreciation and amortization (Note 3)	(2,362,850)	(2,343,812)
Net property and equipment	243,172	288,890
Other Assets		
Cash surrender value of officers' life insurance	24,454	23,610
Other	1,460	20,766
Total other assets	25,914	44,376
Total assets	$ 6,053,132	$ 5,560,664

See accountant's review report and notes to financial statements.

Maxon Contractors, Inc.

Statements of Assets, Liabilities and Equity
Federal Income Tax Basis

Years Ended December 31, 19X8 and 19X7
(continued)

Liabilities and Stockholders' Equity	**19X8**	**19X7**
Current Liabilities		
Accounts payable and accruals (Note 4)	$ 548,646	$ 288,904
Billings in excess of costs on uncompleted contracts (Note 5)	976,754	445,108
Total current liabilities	1,525,400	734,012
Contributed Capital		
Common stock, $1,000 par value; 100 shares authorized; 60 shares issued and outstanding	60,000	60,000
Retained Earnings	4,467,732	4,766,652
Total stockholders' equity	4,527,732	4,826,652
Total liabilities and stockholders' equity	$ 6,053,132	$ 5,560,664

See accountant's review report and notes to financial statements.

Maxon Contractors, Inc.

Statements of Operations and Retained Earnings
Federal Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Contract revenue	$ 7,009,498	$ 8,116,380
Cost of contract revenue		
Direct costs		
Materials and supplies	1,710,330	1,729,310
Salaries and wages	1,184,132	1,264,664
Subcontracts	1,670,596	1,838,942
Other	99,486	92,560
	4,664,544	4,925,476
Indirect costs	813,520	967,278
	5,478,064	5,892,754
Gross profit	1,531,434	2,223,626
General and administrative expenses		
Salaries and wages	1,298,552	2,139,444
Profit-sharing plan contribution	—	6,138
Other	596,938	539,786
	1,895,490	2,685,368
Operating loss	(364,056)	(461,742)
Financing income	88,148	132,590
Net loss	(275,908)	(329,152)
Retained earnings, beginning of year	4,766,652	5,255,804
Distributions to stockholders	(23,012)	(160,000)
Retained earnings, end of year	$ 4,467,732	$ 4,766,652

See accountant's review report and notes to financial statements.

Maxon Contractors, Inc.

Statements of Cash Flows
Federal Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Cash flows from operating activities		
Net loss	$ (275,908)	$ (329,152)
Noncash items included in net loss:		
Depreciation	45,718	60,204
(Increase) decrease in:		
Contract receivables	(987,286)	2,103,570
Inventory	(91,514)	(3,260)
Cash surrender of officers' life insurance	(844)	(1,200)
Other assets	—	(408)
Increase (decrease) in:		
Accounts payable and accruals	259,742	(100,832)
Billings in excess of costs on uncompleted contracts	531,646	(895,508)
Net cash (used) provided by operating activities	(518,446)	833,414
Cash flows from investing activities		
Property and equipment purchases	—	(60,000)
Advances to officers	(7,812)	—
Decrease in certificates of deposit	—	2,132,038
Decrease in other assets	19,306	—
Net cash provided by investing activities	11,494	2,072,038
Cash flows from financing activities		
Distributions to stockholders	(23,012)	(160,000)
Net (decrease) increase in cash and cash equivalents	(529,964)	2,745,452
Cash and cash equivalents, beginning of year	3,608,930	863,478
Cash and cash equivalents, end of year	$ 3,078,966	$ 3,608,930

See accountant's review report and notes to financial statements.

Maxon Contractors, Inc.

Notes to Financial Statements
Federal Income Tax Basis

December 31, 19X8 and 19X7

Note 1—Summary of Significant Accounting Policies

Nature of Operations

Maxon Contractors is a general contractor primarily engaged in the construction of commercial and multi-family residential projects in the San Diego metropolitan area.

Basis of Accounting

The accompanying financial statements have been prepared on the accrual method of accounting used for federal income tax purposes.

If the accompanying financial statements were prepared in conformity with generally accepted accounting principles, contract revenue and costs would be recognized under the percentage-of-completion method of accounting, an allowance for uncollectibe accounts receivable would be established, property and equipment would be depreciated over their estimated useful lives, and the related party lease would be capitalized as an asset and liability.

The Corporation has elected to be treated as a Small Business Corporation (S Corporation) under Internal Revenue Code Section 1362. This election provides that, in lieu of corporate income taxes, the taxable items and credits pass directly to the stockholders. Therefore, these financial statements do not include federal or state income taxes that would otherwise be applicable.

The Corporation uses the accrual completed contract method to recognize construction revenue. That method of accounting recognizes contract revenue and costs when a contract is completed or substantially completed. A contract is considered substantially completed when all costs except insignificant items have been incurred and the installation has been accepted by the customer.

Contract costs include all direct material and labor costs and those indirect costs related to contract performance, such as rent, depreciation, maintenance, and insurance. Indirect costs are allocated based on contract revenue. General and administrative costs are charged to expenses as incurred.

Amounts billed in excess of costs are classified as current liabilities under billings in excess of cost on uncompleted contracts. Contract retentions are included in contract receivables.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Cash and Cash Equivalents

Cash and cash equivalents consist of highly liquid investments with a maturity of three months or less when purchased.

At year end and throughout the year, the Corporation had on deposit with several banks amounts in excess of FDIC insurance limits. The Corporation has not experienced any losses in such accounts. The Corporation believes it is not exposed to any significant credit risk on cash and cash equivalents.

Contract Receivables

Contract receivables, including retentions, are recorded as progress billings are rendered in accordance with the provisions of the contracts. The Corporation uses the direct write-off method to record uncollectible accounts in compliance with the Internal Revenue Code.

Inventory

Inventory is valued at the lower of cost, based on the first-in, first-out method, or market.

Property and Equipment

Property and equipment are recorded at cost and depreciated using principally accelerated methods. Leasehold improvements are amortized over the life of the related leases or their estimated useful lives, whichever is shorter.

Property and equipment are depreciated over the following recovery periods;

Machinery and equipment	5 years
Transportation equipment	5 years
Office furniture and equipment	5–7 years
Leasehold improvements	10–31.5 years

Expenditures for maintenance and repairs that do not materially extend the lives of the assets are charged to earnings. When property or equipment is sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the respective accounts, and the resulting gain or loss is reflected in earnings.

Profit-Sharing Plan

The Corporation adopted a profit-sharing plan effective November 22, 19V4. Substantially all full-time employees are eligible to participate. The Corporation's contributions on behalf of its employees are determined annually by the Board of Directors. The Corporation did not make a contribution for 19X8. Profit-sharing contributions were $3,069 for the year ended December 31, 19X7.

Statement of Cash Flows

For purposes of the statement of cash flows, cash and cash equivalents include money market accounts and operating bank accounts.

The Corporation did not pay any interest expense for 19X8 and 19X7.

Note 2—Contract Receivables

An aging summary of contract receivables at December 31, is as follows:

	19X8	19X7
Billed		
Current	$ 1,131,718	$ 364,284
30 days	486,854	306,318
60 days	189,138	79,914
90 days and over	129,326	258,478
	1,937,036	1,008,994
Unbilled retentions	456,512	319,046
Unbilled amounts on completed contracts	16,006	94,228
Totals	$ 2,409,554	$ 1,422,268

Completed and uncompleted contract receivables at December 31, are as follows:

	19X8	19X7
Completed contracts		
Billed, including retentions	$ 906,052	$ 706,966
Unbilled retentions	116,772	125,206
Unbilled amounts on completed contracts	16,006	94,228
Uncompleted contracts		
Billed	1,030,984	302,028
Unbilled retentions	339,740	193,840
Totals	$ 2,409,554	$ 1,422,268

Receivables written off as uncollectible totaled $30,158 for the year ended December 31, 19X8 and $2,000 for the year ended December 31, 19X7. Recoveries of receivables written off an uncollectible totaled $17,000 for the year ended December 31, 19X7.

Note 3—Depreciation and Amortization

The accumulated depreciation and amortization balances at December 31, are as follows:

	19X8	19X7
Machinery and equipment	$ 1,689,162	$ 1,701,064
Transportation equipment	308,130	296,002
Office furniture and equipment	161,612	160,440
Leasehold improvements	203,946	186,306
Totals	$ 2,362,850	$ 2,343,812

Note 4—Accounts Payable and Accruals

Accounts payable and accruals consist of the following at December 31:

	19X8	19X7
Trade accounts payable	$ 343,222	$ 157,726
Subcontract payables	156,130	86,104
Accrued payroll	40,626	39,814
Accrued and withheld payroll taxes	3,124	860
Sales tax payable	5,544	4,400
Totals	$ 548,646	$ 288,904

Note 5—Billings in Excess of Costs on Uncompleted Contracts

Billings in excess of costs on uncompleted contracts at December 31 are as follows:

	19X8	19X7
Billings on uncompleted contracts	$ 4,320,008	$ 2,258,286
Costs incurred on uncompleted contracts	(3,343,254)	(1,813,178)
Billings in excess of costs on uncompleted contracts	$ 976,754	$ 445,108

Note 6—Commitment Under Lease Agreement

On December 15, 19V6, the Corporation signed a lease with its stockholders for an office and production facility located in Mira Mesa, California. The facility lease is for 25 years, terminating December 15, 200Y. The base annual rent was $343,000 for 19X8 and 19X7. Increases in the base annual rent are to be based on the Consumer Price Index, not to exceed 6 percent. The stockholders pay the real estate taxes and the Corporation pays all maintenance charges and operating costs for the facility. The rental payments include an escalation for increases in real estate taxes.

At December 31, 19X8, the aggregate minimum lease payments under this lease were approximately $2,800,000. Future minimum lease payments are scheduled to be approximately $350,000 for each of the next 5 years. Rent expense for each of the years ended December 31, 19X8 and 19X7 was $353,000.

Note 7—Backlog

The estimated gross revenue on work to be performed on signed contracts was $3,467,894 at December 31, 19X8 and $4,183,624 at December 31, 19X7. In addition to the backlog of work to be performed, there was gross revenue to be reported in future periods under the accrual completed contract method used by the company of $1,548,173 at December 31, 19X8 and $1,668,961 at December 31, 19X7.

EMMA N. CHIPMAN 1964
IRREVOCABLE TRUST
ANNUAL REPORT
FOR THE YEARS ENDED
DECEMBER 31, 19X8 AND 19X7

Author's Note. The following statements of a trust have been prepared on the tax-basis. These statements illustrate the following.

- *The financial statements do not include a statement of cash flows, which is acceptable for an OCBOA presentation. In this case, a statement of cash flows probably is not warranted because (1) the users of the financial statements are more interested in asset balances rather than cash flows and (2) if cash flow information is needed, it could easily be derived from the information presented.*

When reading the notes to these financial statements, you may wish to note the following.

- *The notes to the financial statements include extensive disclosure information about the fair value of marketable securities. Interpretation 14 of SAS No. 62 states that GAAP disclosure requirements that are not relevant to the measurement of an item need not be considered, for example the disclosure of fair value of marketable securities when those securities are presented at cost. However, the preparers of these financial statements have provided fair value information because it is useful and relevant for the financial statement users.*

Accountant's Compilation Report

To the Trustee
Emma N. Chipman 1964 Irrevocable Trust

We have compiled the accompanying statements of assets, liabilities and corpus—income tax-basis of Emma N. Chipman 1964 Irrevocable Trust as of December 31, 19X8 and 19X7, and the related statements of revenues, expenses and corpus—income tax-basis for the years then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the trustee. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[Signature of Firm]

[City and State]

[Date]

Emma N. Chipman 1964 Irrevocable Trust

Statements of Assets, Liabilities and Corpus
Income Tax Basis

December 31, 19X8 and 19X7

Assets	**19X8**	**19X7**
Marketable securities—at cost (market value $2,746,922 and $2,353,519 in 19X8 and 19X7, respectively)	$ 1,830,087	$ 1,560,681
Purchased interest	340	—
Total assets	$ 1,830,427	$ 1,560,681
Liabilities and Corpus		
Income Taxes payable	$ 53,710	$ 9,460
Due to beneficiary	104,236	65,842
Total liabilities	157,946	75,302
Corpus	1,672,481	1,485,379
Total Liabilities and Corpus	$ 1,830,427	$ 1,560,681

See accompanying notes and accountant's compilation report.

Emma N. Chipman 1964 Irrevocable Trust

Statements of Revenues, Expenses and Corpus
Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Revenues		
Dividends	$ 76,139	$ 69,044
Interest	4,729	4,457
Gain (loss) on sale of securities, net	201,370	46,094
Total revenues	282,238	119,595
Expenses		
Accounting fee	7,500	7,000
Bank custodian fee	3,018	2,588
Investment counsel fee	9,474	7,588
Total expenses	19,992	17,176
Income before provision for income taxes	262,246	102,419
Provision for income taxes	75,144	22,207
Net income	187,102	80,212
Corpus, beginning of year	1,485,379	1,405,167
Corpus, end of year	$ 1,672,481	$ 1,485,379

See accountant's review report and notes to financial statements.

Emma N. Chipman 1964 Irrevocable Trust

Notes to Financial Statements
Income Tax Basis

For the Years Ended December 31, 19X8 and 19X7

Note 1—Nature of Trust and Significant Accounting Policies

Nature of Trust

The Emma N. Chipman 1964 Irrevocable Trust (the "Trust") was created on May 5, 1964 by Doris W. Chipman. Distribution of 25 percent of principal is to be made at age thirty, and 33-1/3 percent at age thirty-five. After January 1, 19X2, the beneficiary may request annually a noncumulative distribution of the larger of $5,000 or 5 percent of the principal as of the end of the year. Upon death of the beneficiary, the Trust is to be distributed according to the terms of her will. The trustee has discretionary power to distribute principal and/or income.

Basis of Accounting

The accompanying financial statements have been prepared on the cash method of accounting used for federal income tax purposes. Consequently, certain revenues and expenses are recognized in the determination of income in different reporting periods than they would be if the financial statements were prepared in conformity with generally accepted accounting principles. Although income tax rules are used to determine the timing of the reporting of revenues and expenses, nontaxable revenues and nondeductible expenses are included in the determination of net income.

Use of Estimates

The preparation of financial statements in conformity with the cash method of accounting used for federal income tax purposes requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Marketable Securities

Marketable securities are carried at cost. The cost of marketable securities sold is based on cost as determined under the specific identification method.

Note 2—Marketable Securities

At December 31, 19X8 and 19X7, gross unrealized gains and losses pertaining to marketable securities in the portfolio were as follows:

	Cost	Market Value	Unrealized Gains	Unrealized Losses
19X8				
Equities	$ 948,766	$ 1,790,955	$ 854,565	$ 12,376
Fixed income and money market	881,321	955,967	119,362	44,716
Total	$ 1,830,087	$ 2,746,922	$ 973,927	$ 57,092

	Cost	Market Value	Unrealized Gains	Unrealized Losses
19X7				
Equities	$ 891,685	$ 1,611,732	$ 757,910	$ 37,863
Fixed income and money market	668,996	741,787	72,791	—
Total	$ 1,560,681	$ 2,353,519	$ 830,701	$ 37,863

Note 3—Income Taxes

The income tax expense shown in the accompanying financial statements differs from the expense that would result from applying statutory tax rates to income before income taxes primarily because of capital gains. Distributions to beneficiaries are allowed as a deduction from taxable income for the trust in the year in which such distributions are made.

The provision for income taxes for the years ended December 31 consists of:

	19X8	19X7
Federal	$ 63,200	$ 17,874
State	11,944	4,333
Provision for income taxes	$ 75,144	$ 22,207

HUDSON STREET PARTNERS
FINANCIAL STATEMENTS
FOR YEARS ENDED
DECEMBER 31, 19X8 AND 19X7

Author's Note. The following statements of a real estate limited partnership have been prepared on the tax-basis. These statements illustrate the following.

- *The presentation of the financial statements essentially conforms to a GAAP presentation of a real estate entity. For example, the assets and liabilities are unclassified, with the property and related mortgage debt being listed first in the presentation.*

- *The notes have been tailored to meet the needs of the limited partners, who are the primary users of the financial statements. For example, very little information is disclosed relating to the terms of the partnership agreement, the allocation of profits and losses, etc. This type of information is available in the partnership agreement, which is readily available to the limited partners. On the other hand, information about the complex financing arrangements of the partnership may not be available to the limited partners. Thus, the financial statements include a great deal of information describing the terms of the first mortgage loan.*

- *As described in Note 5 to the financial statements, the entity is obligated under notes payable to its partners. Under the tax rules, interest on these notes is not deductible until paid. For financial reporting purposes, the entity recognizes an accrual for unpaid interest on notes payable to partners and adds this amount to the outstanding principal balance of the loans. The offsetting debit has been reported as an asset, described as "Deferred interest expense." The advantage to this presentation method is that the statement of operations is a truer reflection of the tax return.*

  Alternatively, the entity might have chosen to report changes in the accrued interest balance as a nondeductible expense in the statement of operations. The advantage to this practice is that it more accurately reflects the results of the entity during the period, assuming that the total amount of the deferred interest eventually will be paid. In practice, both methods of reporting nondeductible interest to partners are used.

Independent Auditor's Report

To the Partners
Hudson Street Partners

We have audited the accompanying statement of assets, liabilities and partners' deficit—income tax-basis of Hudson Street Partners as of December 31, 19X8 and 19X7, and the related statements of revenues and expenses—income tax-basis, changes in partners' deficit—income tax-basis and cash flows—income tax-basis for the years then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provides a reasonable basis for our opinion.

As described in Note 1, these financial statements were prepared on the accounting basis used for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities and partners' deficit of Hudson Street Partners as of December 31, 19X8 and 19X7, and its revenues and expenses, changes in partners' deficit and cash flows for the years then ended on the basis of accounting described in Note 1.

[Signature of Firm]

[City and State]

[Date]

Hudson Street Partners

Statements of Assets, Liabilities and Partners' Deficit—Income Tax Basis

December 31, 19X8 and 19X7

Assets	19X8	19X7
Investment in Real Estate	$ 2,156,462	$ 2,226,770
Other Assets		
Cash	18,453	24,058
Accounts receivable	123,850	55,677
Mortgage escrows	428,417	418,503
Prepaid insurance	7,645	7,743
Deferred financing costs	396,708	418,575
Deferred interest expense	765,825	689,173
Other	928	1,784
Total other assets	1,741,826	1,615,513
Total Assets	$ 3,898,288	$ 3,842,283
Liabilities and Partners' Deficit		
Mortgages Payable	$ 2,974,474	$ 3,012,551
Other Liabilities		
Loans payable to partners	2,836,821	2,479,728
Bank overdraft	—	2,622
Accounts payable	52,374	92,880
Tenant security deposits	13,680	19,175
Accrued expenses	271,543	254,254
Total other liabilities	3,174,418	2,848,659
Total liabilities	$ 6,148,892	$ 5,861,210
Partners' Deficit	(2,250,604)	(2,018,927)
Total Liabilities and Partners' Deficit	$ 3,898,288	$ 3,842,283

See accompanying notes.

Hudson Street Partners

Statements of Revenues and Expenses—Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Revenues		
Rental rentals	$ 493,890	$ 376,818
Interest on escrow accounts	19,506	27,517
Miscellaneous	4,080	3,150
Total revenues	517,476	407,485
Expenses		
Advertising	—	1,710
Salaries and related expenses	52,382	52,093
Administration	4,134	4,219
Professional fees	16,214	18,705
Operating and maintenance	55,338	63,382
Utilities	44,175	43,208
Management fees	25,707	18,417
Insurance	10,292	10,582
Real estate taxes	63,469	59,491
Interest	363,700	364,494
Bond servicing and trustee fees	7,129	9,433
Miscellaneous	—	905
Total expenses	642,540	646,639
Loss before depreciation and amortization	(125,064)	(239,154)
Depreciation and amortization	106,613	102,642
Net Loss	$ (231,677)	$ (341,796)

See accompanying notes.

Hudson Street Partners

Statements of Changes in Partners' Deficit
Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	General Partner	Limited Partners	Total
Partners' deficit, January 1, 19X6	$ (16,619)	$ (1,660,512)	$ (1,677,131)
Net loss	(3,418)	(338,378)	(341,796)
Partners' deficit, December 31, 19X7	(20,037)	(1,998,890)	(2,018,927)
Net loss	(2,317)	(229,360)	(231,677)
Partners' deficit, December 31, 19X8	$ (22,354)	$ (2,228,250)	$ (2,250,604)

See accompanying notes.

Hudson Street Partners

Statements of Cash Flows— Income Tax Basis

Years Ended December 31, 19X8 and 19X7

	19X8	19X7
Operating Activities		
Net loss	$ (231,677)	$ (341,796)
Depreciation and amortization	106,613	102,642
Accrued interest added to the outstanding principal balance of loans payable to partners	207,114	270,451
Changes in		
Accounts receivable	(22,497)	(32,998)
Other receivables	(45,676)	(12,531)
Mortgage escrows	(9,914)	(22,349)
Prepaid insurance	98	258
Deferred interest expense	(76,653)	(53,896)
Other assets	858	(1,765)
Accounts payable	(40,506)	82,463
Accrued expenses	17,290	20,072
Net cash applied to operating activities	(94,950)	10,551
Investing Activities		
Purchase of equipment	(14,438)	(57,852)
Net cash applied to investing activities	(14,438)	(57,852)
Financing Activities		
Repayment of first mortgage loan	(38,077)	(38,077)
Decrease in tenant security deposits	(5,497)	(9,352)
Repayment of partners' loans	(128,686)	(180,000)
Proceeds from partners' loans	278,665	285,150
Net change in bank overdraft	(2,622)	3,788
Net cash provided by financing activities	103,783	61,509
Increase (decrease) in cash	(5,605)	14,208
Cash, beginning of year	24,058	9,850
Cash, end of year	$ 18,453	$ 24,058

Supplemental Disclosure of Cash Flow Information

	19X8	19X7
Interest paid		
Current year	$ 217,990	$ 164,685
Prior year accruals which had been added to outstanding loan balances	128,686	180,000
Total interest paid	$ 346,676	$ 344,685

Hudson Street Partners

Notes to Financial Statements

December 31, 19X8 and 19X7

Note 1—Nature of Operations and Significant Accounting Policies

Nature of Operations

Hudson Street Partners (the "Partnership") was formed on October 3, 1986, for the purpose of acquiring, renovating, leasing and operating a 9-story, 66-unit apartment building with 2,553 square feet of commercial space ("Property") in Denver, Colorado.

The acquisition and renovation of the Property were financed by a loan funded by tax-exempt bonds issued by the City of Denver and by a loan from the City of Denver funded by Housing Development Grant Funds. In order to obtain and retain and tax-exempt status of the bonds, 20 percent of the units are required to be available to qualifying low-income tenants for a period of fifteen years commencing in February 19Y4.

Pursuant to the partnership agreement ("Agreement"), except for profits and losses from a major capital event, as defined, profits are allocated first to partners in proportion to deficit capital account balances and then in accordance with the percentage stated in the Agreement and losses are allocated in accordance with the stated partners' percentages. Notwithstanding the foregoing, not less than 1 percent of profits and losses will be allocated to the general partner. Rehabilitation credits are first allocated based on partner capital contributions, loans made to and guaranteed by the partners and then in accordance with the stated partners' percentages. Additionally, a cumulative preferred return, as defined, is provided to partners making contributions in excess of the initial capital requirements.

Basis of Accounting

The financial statements are prepared on the income tax-basis of accounting using the accrual method. This basis of accounting differs from generally accepted accounting principles ("GAAP") in that the building is being depreciated over statutory recovery periods as required by the Internal Revenue Code ("IRC") rather than its estimated useful life, interest expense incurred on loans from related parties is recognized when paid pursuant to IRC Section 267 and the depreciable basis of the building and partners' capital have been reduced by the amount of the rehabilitation credit available to the individual partners while GAAP does not provide for such reductions.

Although income tax rules are used to determine the timing of the reporting of revenues and expenses, nontaxable revenues and nondeductible expenses are included in the determination of net income in the accompanying financial statements.

Use of Estimates

The preparation of financial statements in conformity with the income tax-basis of accounting required management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Investment in Real Estate

Investment in real estate is recorded at cost. Cost includes interest, real estate taxes, insurance and other pertinent costs associated with the acquisition, development and rehabilitation of the property. Depreciation is provided using the Accelerated Cost Recovery System ("ACRS") and Modified ACRS over statutory recovery periods as follows:

	Statutory Period (Years)	Method
Building and improvements	19, 31.5, 20	Straight line
Equipment	7–10	200% declining balance

The residential portion of the building is depreciated on a straight line basis over 40 years, which is required for tax exempt bond financed property. The cost basis of the building has been reduced by the rehabilitation tax credit of $646,283.

Deferred Financing Costs

City of Denver Multi-Family Housing Bonds. Financing fees of $494,856, including the cost of the insurance policy required by the tax-exempt bond indenture, were capitalized and are being amortized on a straight line basis over 30 years, the term of the loan and underlying bonds.

Housing Development Grant. Financing fees of $107,433 were capitalized and are being amortized on a straight line basis over 20 years, the life of the loan.

Income Taxes

The net income, loss and tax credits generated by the Partnership are attributable to the individual partners; consequently, no federal income tax provision has been included in these financial statements.

The Partnership is entitled, under IRC Section 42, to a low-income housing tax credit with respect to qualified housing placed in service after January 1, 1987. The credit is available for a period of ten years, beginning in February 19Y4, when the property was placed in service. Since this project is federally assisted, the annual credit, which approximates $20,000, is 3.92 percent of the "qualified basis." Qualified basis is that portion applicable to the percentage of floor space or housing units available for occupancy by low-income tenants.

The Partnership is contractually obligated to make 20 percent of the floor space or housing units available for occupancy by low-income tenants. In order for the credit to be available, the project must qualify as low-income housing, not only on the date placed in service, but also throughout the "compliance period," which is a period of 15 years beginning in February 19Y4.

The requirements for the low-income housing tax credit must be met over the 15-year compliance period and noncompliance can result, at the Partnership level, in recapture of one-third of the previously utilized credits, plus interest on the deficiency from the due date of the tax return on which the credits were utilized.

Reclassifications

Certain amounts previously reported have been reclassified to conform to the current year's presentation.

Note 2—Investment in Real Estate

Investment in real estate at December 31 consisted of:

	19X8	19X7
Land	$ 69,500	$ 69,500
Building and improvements	2,616,226	2,610,827
Equipment	174,721	165,682
Total	2,860,447	2,846,009
Less accumulated depreciation	703,985	619,239
Net investment in real estate	$ 2,156,462	$ 2,226,770

Note 3—Accounts Receivable

Accounts receivable at December 31 consisted of:

	19X8	19X7
Tenants	$ 66,318	$ 52,578
Management agent	45,224	—
Other	12,308	3,099
Total	$ 123,850	$ 55,677

Note 4—Mortgages Payable

Mortgages payable at December 31 consisted of:

	19X8	19X7
First mortgage loan, 6.626% interest rate, interest only was payable through February 1, 19X6, at which time monthly payments commenced of interest plus 1/12 of the next annual principal payment due on the underlying bonds. Annual principal payments commenced at $35,000 on February 1, 19X6 and increase annually to $290,000 at maturing on February 1, 20ZZ.	$ 2,380,000	$ 2,445,000
Second mortgage loan, 3% interest rate, annual debt service payments equal to 50% of net cash flow, as defined, to be applied first to accrued interest and then to outstanding principal. Unpaid accrued interest and principal are due December 23, 2008.	567,551	567,551
Other	26,923	—
Mortgages payable	$ 2,974,474	$ 3,012,551

Maturities of long-term debt in each of the next five years will be:

Years Ending December 31	Amount
19X9	$ 70,000
20XX	80,000
20XY	95,000
20XZ	100,000
20YA	105,000
Thereafter	2,524,474
Total	$ 2,974,474

The first mortgage loan was funded from the proceeds of the sale of $2,600,000 of Multi-Family Housing Revenue Bonds—Series 1987 issued by the City of Denver, Colorado ("Bonds"). In connection with the initial issuance, the Partnership paid bond issuance costs approximating $152,200. The Bonds bear interest at the rate of 6.625 percent per annum and are subject to mandatory annual redemption in the principal amounts corresponding to the principal payments due under the first mortgage. The bond indenture also provides for redeterminations of the interest rate of the Bonds in 19X9, 20XZ, 201A and 201C which will affect the interest to be paid by the Partnership. The interest rate redetermination process requires the mandatory tender for purchase or redemption of all bonds outstanding at the interest rate redetermination date. At the scheduled tender date, the tendered bonds, for which the holder has not elected to retain, are then to be remarketed at a new interest rate established for the ensuing term prior to the next scheduled interest rate redetermination (see Note 9).

The Partnership is required, under the bond indenture, to maintain four separate escrows for the disbursement of funds in connection with the bond issue. These escrows are:

Debt Service Escrow. The debt service escrow is a reserve for debt service payments. A minimum balance of $210,000 is required. Excess funds, if any, are periodically transferred to the bond interest escrow.

Bond Interest Escrow. The Partnership makes monthly deposits equivalent to one-twelfth of the principal and interest payments due on the Bonds during the year. Debt service payments are disbursed from this escrow.

Agent Fees Escrows. The Partnership is required to pay semiannual fees to the City of Denver, as issuer of the Bonds, and annual fees to the mortgage insurance agent. Two escrows have been established with the trustee, whereby the Partnership deposits funds monthly, to be disbursed by the trustee when the Partnership is required to satisfy its obligations.

To provide the credit enhancement mandated by the bond indenture as collateral for debt service payments, an insurance policy was purchased for a premium of $237,000 which insures the funding of all debt service payments should amounts in the debt service escrow be insufficient to meet the prescribed payments. The policy expired in February 19X9 and was subsequently renewed. Additionally, as a condition of the issuance of the insurance policy, the Partnership has entered into a reimbursement agreement with the insurer in which it has agreed to repay the insurer for any disbursements made pursuant to the conditions of the policy. The bond indenture also required two of the limited partners to provide, jointly and severally, their personal guaranty that the Partnership will meet all financial obligations under the various agreements up to a maximum of $1,300,000. The level of the guaranty reduces in stages to zero based upon the Partnership achieving certain levels of net operating income, as defined in the agreement. The guaranty of the limited partners was released by all parties as of February 3, 19X9 as a result of the Partnership achieving the required levels of defined net operating income in 19X8.

In order to maintain the tax-exempt status of the bonds, the Partnership must also conduct its operations and maintain the Property in a manner which complies with the applicable provisions of the Internal Revenue Code while the Bonds are outstanding.

As additional conditions of the bond indenture, the Partnership was required to and did fund all costs in excess of the mortgage loan proceeds necessary to complete the rehabilitation of the project and is obligated to pay annual bond trustee and mortgage service fees and expenses. The bond trustee and service fees, exclusive of any expenses for which the Partnership might be liable, were charged at the initial annual amounts of $1,700 and $4,780, respectively, commencing February 19X4, and provide for annual fee reductions based upon the decline in the outstanding balances of the Bonds and mortgage loan.

The second mortgage loan was funded from the proceeds of a housing development grant made to the City of Denver from the United States Department of Housing and Urban Development. The provisions of this loan generally parallel those of the first mortgage loan and underlying bond indenture. The second mortgage lender has subordinated the debt service payments of this loan to allow the Partners to receive a noncumulative 14 percent return on equity, as defined. Additionally, the loan may not be prepaid, other than through the stipulated annual debt service payments, prior to its maturity.

Note 5—Loans Payable to Partners

The loans payable to three of the limited partners bear interest at the corporate base rate announced by the First National Bank of Denver plus 2 percent, compounded annually, and are repayable to the extent that cash receipts are not required to meet debt service obligations or other purposes designated by the general partner, or, if not sooner paid, paid from residual proceeds, as defined. Accrued interest not paid during any year is capitalized as "deferred interest expense" pursuant to the IRC and added to the outstanding principal balance of the loans. During 19X8 and 19X7, interest capitalized and added to the outstanding loan balance amounted to $207,114 and $270,4510, respectively.

During 19X8, the Partnership received loans totaling $168,500 from a limited partner and repaid $168,500 of the then existing outstanding loan balance due to other partners. As a result of these payments, $128,686 of deferred interest expense was recognized as expense in 19X8.

Note 6—Transactions With General Partners and Affiliates

A corporation, in which stockholders of the general partner are stockholders, provides assistance to the Partnership and other affiliates in arranging for insurance coverage. Insurance premiums paid to insurers through this affiliate of the general partner totaled $10,724 and $10,913 for the years ended December 31, 19X8 and 19X7, respectively. In 19X8, $31,000 of funds loaned to the Partnership were used to reduce the outstanding liability to this affiliate. Insurance premiums payable to this affiliate of the general partner at December 31, 19X8 and 19X7 totaled $13,566 and $29,844, respectively.

Note 7—Management and Leasing Fees

The Partnership has entered into a property management agreement which provides for the payment of a fee equal to 5 percent of gross collections, as defined, in return for the property management agent's services. The agent is also entitled to receive a leasing fee for commercial space equal to 3 percent of gross receipts due under the lease, payable when the tenant commences payments under the lease and an additional 1 percent of gross receipts payable under the terms of a renewed lease. The agreement commenced November 1, 19Y6, and is automatically renewed annually unless written notification of termination is provided. Management fee expense was $25,707 and $18,417 for the years ended December 31, 19X8 and 19X7, respectively.

Note 8—Leases

The Partnership generally leases apartment units to tenants for a term of one year, which applies to both low income and market rate tenants. The commercial leases have varying terms which expire through 200X.

On July 1, 19X7, the Partnership entered into a master lease arrangement with Max Leasing, Inc. wherein all units, with the exception of units designated as available for low income qualifying tenants, becoming vacant during the term of the master lease become subject to the terms of the master lease. The term of the master lease was for an initial eleven-month period ending May 31, 19X8, subject to automatic annual renewal with termination to occur thereafter with ninety days notice by either party. Among other things, the master lease requires monthly payments from $700 to $950 per month depending on the size of the respective unit. Initially, ten units were subject to the master lease with 34 units being subject to the master lease at December 31, 19X8. The master lease has not been renewed as of December 1, 19X8. Effective January 1, 19X9 Max Leasing, Inc. reassigned all its leases to the Partnership.

Future minimum lease payments under noncancelable commercial leases are as follows:

Years Ending December 31	Amount
19X9	$ 42,204
20XX	42,058
20XY	33,352
20XZ	24,857
Total	$ 142,471

Note 9—Bond Interest Redetermination

As required by Section 305 of the Bond Indenture, on December 31, 19X8, the trustee notified the bond holders that all the outstanding bonds, with the exception of those scheduled for mandatory redemption on February 1, 19X9, were to be tendered for redemption for the purpose of reissuing those bonds with an adjusted interest rate which would be in effect for the next five years, the period until the next mandated interest reset. As a result of that notice, bond holders who held bonds with the principal value of $245,000 elected to retain the bonds and the remaining bonds with a principal value of $2,105,000 were remarketed. In accordance with the provisions of the indenture, an interest rate of 5.5 percent per annum was set, the credit enhancement, consisting of an amendment of the existing bond insurance policy, was provided and the respective bonds were remarketed with an "A-" rating. All bonds subject to remarketing were sold.

As a result of the redemption and reissuance, the bonds in the amount of $2,350,000, bear interest at the rate of 5.5 percent per annum, payable semiannually, and are subject to the same annual mandatory redemption provisions as contained in the initial offering, except that the bonds may be redeemed at par by the Partnership with the provision of 60 days notice and compliance with certain other terms of the loan agreement and the indenture relating to the exercise of this option.

In connection with the reissuance, the bond insurance policy was extended for a period of 5 years and 124 days and remains in force subject to the payment of an annual maintenance fee equal to 2 percent of the outstanding principal amount of the bonds. The initial fee of $54,700 was paid to the insurer prior to February 1, 19X9, the remarketing date. Annual premium payments are due on February 1 of the remaining four-year term. In addition to the payment of the annual premium, the insurer required that the original reimbursement agreement be reaffirmed and amended to provide, among other things, for the payment of the annual premium and the institution of cross-default provisions with a new guaranty provided by two limited partners. As the provisions of the initial guaranty provided by the two limited partners had lapsed pursuant to its terms, the insurer, as a condition of amending the insurance policy, required the two limited partners to execute a second guaranty which obligates them to reimburse the insurer for any losses it incurs arising from certain defined acts, which generally are acts prohibited by the indenture and other applicable documents, and limits their obligation for enforcement costs, as defined, to $70,000.

The indenture, with the consent of the insurer, also provided for the release of $58,200 from the Debt Service Escrow for use in paying certain costs incurred in connection with the remarketing and the transfer of $89,180 from the Debt Service Escrow to the Bond Interest Escrow to be used to meet the Partnership's monthly principal and interest payment obligations.

CHAPTER 6
EXAMPLE DISCLOSURES

As described in chapter 3 of this publication, SAS No. 62 describes three general types of financial statement disclosures.

- A summary of significant accounting policies, including the basis of accounting used to prepare the financial statements.
- Informative disclosures related to items included in the financial statements.
- Other disclosures related to items not specifically identified on the face of the financial statements.

This following compilation of example disclosures is organized in a similar fashion.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF ACCOUNTING

Author's Note: As described in chapter 3 of this publication, SAS No. 62 requires OCBOA financial statements to describe the basis of presentation and how that basis differs from GAAP. Quantifying this difference is not required. Interpretation 14 of SAS No. 62 clarifies that this description may be brief and that only the primary differences from GAAP need to be described.

The amount of detail provided when describing the differences between the OCBOA and GAAP will vary according to the circumstances and the judgment of the preparer. The following examples illustrate a variety of approaches.

Cash-Basis

The Company prepares its financial statements on the cash-basis of accounting but includes refundable and prepaid income taxes and liabilities for payroll withholdings payable. Under this basis, revenues are recognized when collected rather than when earned and expenses generally are recognized when paid rather than when incurred. Consequently, accounts receivable due from patients, trade accounts payable and prepaid and accrued expenses, other than those mentioned above, are not included in the accompanying financial statements.

* * * * *

The accompanying financial statements have been prepared using the modified cash-basis of accounting. Under this method, revenues are recognized when collected rather than when earned, and expenses generally are recognized when paid rather than when incurred. This basic approach is modified to include inventory, fixed assets and the related depreciation, liabilities for sales tax, accrued payroll taxes, retirement contributions, and income taxes payable. Consequently, accounts receivable due from customers, trade accounts payable, and accrued expenses other than those mentioned above were not included in the financial statements as of September 30, 199X. This method of accounting is also used for income tax reporting purposes.

* * * * *

The Company prepares its financial statements using the cash receipts and disbursements basis of accounting. Under that basis, all transactions are recognized as either cash receipts or disbursements. The only asset is cash; liabilities are not recognized. Noncash transactions, primarily pledges receivable from donors and accounts payable to vendors, and their related effects on the change in net assets are not recognized in the accompanying financial statements.

Tax-Basis

Author's Note. The last paragraph of the following disclosure is not required but may be added as a general disclaimer. See page 29 of this publication for further discussion.

The accompanying financial statements have been prepared from the records and accounts of the Partnership, which are maintained primarily for U.S. federal income tax reporting purposes. Accordingly, such statements do not purport to present the Partnership's financial position, results of operations or changes in partners' capital in conformity with generally accepted accounting principles.

The primary differences between the Company's accounting basis and generally accepted accounting principles are (*a*) inventory capitalization and costing methods and (*b*) the methods and lives used to depreciate fixed assets. Nontaxable income and nondeductible expenses are included in the determination of net income.

Since many types of transactions are susceptible to varying interpretations under federal income tax laws and regulations, the amounts reported in the financial statements may be subject to change at a later date on final determination by the respective taxing authorities.

* * * * *

The Company prepares its financial statements on the cash method of accounting used for Federal income tax purposes. Consequently, certain revenues and expenses are recognized in the determination of income in different reporting periods than they would be if the financial statements were prepared in conformity with generally accepted accounting principles. The primary differences between the Company's accounting basis and generally accepted accounting principles are: 1) depreciation using federal income tax methods and lives, rather than relating the cost of the assets to expense over their estimated useful lives; 2) use of the direct write-off method for bad debts rather than an allowance for uncollectibles; 3) capitalizing of labor and overhead using rules prescribed by the Internal Revenue Service, rather than capitalizing overhead costs according to generally accepted accounting principles; 4) valuation of inventory at cost rather than at lower of cost or market; and 5) expensing obsolete inventory when it is disposed rather than providing a reserve for obsolescence. Although income tax rules are used to determine the timing of the reporting of revenues and expenses, nontaxable revenues and nondeductible expenses are included in the determination of net income.

* * * * *

The Company prepares its financial statements on the accrual basis of accounting used for income tax reporting whereby income and expenses are recorded in accordance with principles and practices used in reporting to the federal government for income tax purposes. This basis differs from generally accepted accounting principles (GAAP) in the following material areas. Tax law does not allow the deduction of interest expense accrued on loans from the majority owner. The interest expense deduction is taken when the interest is paid to the majority owner. GAAP accounting allows the deduction of these expenses in the year accrued. In addition, useful lives and depreciation rates used for property and equipment are those established by income tax law. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with GAAP.

* * * * *

Author's Note. The following note includes a statement that the effect of the departures from GAAP has not been determined, which is not required. Departures from the stated basis of accounting, in this case, the entity's recognition policy for bad debt expense, identified in the last paragraph, will result in a modification to the standard audit report.

The accompanying financial statements have been prepared on the accrual method of accounting used for federal income tax purposes. Although income tax rules are used to determine the timing of the reporting of revenues and expenses, nontaxable revenues and nondeductible expenses are included in the determination of net income. Departures from generally accepted accounting principles include:

a) The accelerated capital cost recovery systems, ACRS and MACRS, have been applied to provide for depreciation for post 1981 additions.

b) No provision has been made for deferred income tax benefits on temporary differences between financial statement income and taxable income.

c) No provision has been made in the financial statements for employees' compensation for future absences as required by SFAS No. 43.

The effect of the above departures from generally accepted accounting principles has not been determined.

The company recognizes a bad debt provision on its financial statements which is in accordance with generally accepted accounting principles and is a departure from the income tax-basis of accounting.

* * * * *

Author's Note. The statement in the first paragraph that the tax-basis "is a comprehensive basis of accounting other than generally accepted accounting principles" is not required.

The accompanying financial statements have been prepared on the accrual completed contract method of accounting used for Federal income tax reporting purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

If the accompanying financial statements were prepared in conformity with generally accepted accounting principles, contract revenue and costs would be recognized under the percentage-of-completion method of accounting, an allowance for uncollectible accounts receivable would be established, property and equipment would be depreciated over their estimated useful lives, and the related party lease would be capitalized as an asset and liability.

Although income tax rules are used to determine the timing of the reporting of revenues and expenses, nontaxable revenues and nondeductible expenses are included in the determination of net income.

* * * * *

The Company prepares its financial statements on the basis used in the preparation of its federal income tax returns. The income tax returns are prepared on the accrual basis, except for income from partnerships. Income from partnerships is reflected as reported by the partnerships for income tax purposes, which in most cases, is on the cash-basis of accounting.

Although income tax rules are used to determine the timing of the reporting of revenue and expenses, nontaxable revenue and nondeductible expenses are included in the determination of net earnings. The following are the Company's significant accounting policies under this basis:

<u>Income Tax</u>. Effective January 1, 19XX, the Company elected under the Internal Revenue Code to be an S corporation. In lieu of corporation income taxes, the shareholders of an S corporation are taxed on their proportionate share of the company's taxable income. Therefore, no provision or liability for income taxes has been included in the financial statements.

<u>Provision for Doubtful Accounts.</u> No provision for doubtful accounts is made. The Company follows the practice of charging off all accounts deemed uncollectible directly to expense.

<u>Property and Equipment</u>. Property and equipment, as well as liabilities pertaining thereto, are recorded at cost as determined for income tax purposes. Leases are not capitalized.

Depreciation is provided on the straight line, declining balance, accelerated cost recovery and the modified accelerated cost recovery systems.

Installment Sales of Real Property. Gross profit on installment sales of real property is reported and recognized as cash is collected. The gross profit included in the related mortgage note receivable is presented as deferred revenue on the statements of assets, liabilities and stockholders' equity.

Differences Between Company Basis of Accounting and Generally Accepted Accounting Principles

Certain of the aforementioned accounting policies and principles would differ under GAAP as follows:

- Gain on the sale of real property would be recognized in one year on the full accrual method, rather on the installment basis.

- Depreciation on property and equipment would be provided on the straight-line method over the estimated useful lives of the assets, rather than on the accelerated basis allowed for income tax purposes.

- Partnership income would be reflected on the accrual basis.

* * * * *

The accompanying financial statements have been prepared using the accrual method of accounting permitted for federal income tax purposes. The following are the primary differences between that basis and generally accepted accounting principles (GAAP).

Presentation of Net Assets and Changes in Net Assets. The accompanying financial statements do not classify net assets as unrestricted, temporarily restricted, and permanently restricted as required under GAAP. Additionally, the changes in those classes of net assets have not been presented in the accompanying financial statements.

Contributions Receivable. Under the tax-basis of accounting, contributions and grants are recognized when received or pledged. Restricted funds are recognized as revenue when the Association complies with the stated restrictions. Amounts received but not yet recognized are reported as deferred restricted support. Under GAAP, contributions received would be classified as restricted if they are received with donor stipulations that limit the use of the donated assets. Under GAAP, when a donor restriction expires or the Association complies with the stated restrictions, temporarily restricted net assets would be reclassified to unrestricted net assets.

Donated Services. The accompanying financial statements do not reflect any amount for donated services. Under GAAP, the fair value of certain contributed services would be recognized as contributions and reported as either assets or expenses in the accompanying financial statements.

OTHER SIGNIFICANT ACCOUNTING POLICIES

Author's Note. SAS No. 62 provides no guidance on other significant accounting policies that should be included in OCBOA financial statements. In practice, most financial statements follow GAAP by disclosing the significant accounting policies used to prepare the financial statements, especially those that involve—

- *A selection from existing acceptable alternatives.*
- *Industry peculiarities.*
- *Unusual or innovative application of accounting principles.*

Other disclosures typically found in the first note to the financial statements, for example, the nature of the entity's operations and the use of estimates, usually follow GAAP disclosures. Note, however, that the standard GAAP language regarding the use of estimates may not apply to certain OCBOA financial statements such as those prepared on a pure cash-basis.

Marketable Securities

The Plan's investments are stated at market value. Securities traded on the national securities exchange are valued at the last reported sales price on the last business day of the plan year. Investments traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the average of the last reported bid and asked prices. For certain corporate bonds that do not have an established market value, the Plan's Board of Trustees has established a market value based on yields currently available on comparable securities of issuers with similar credit ratings. (From a cash-basis financial statement.)

* * * * *

Investments in farm cooperatives are carried at cost or at the value at which they were recorded as income when received. No ascertainable market value is available for these investments, but in the opinion of management, the amount shown does not exceed the value to the overall program of the company. The investment in a utility stock is recorded at the actual cost. (From a cash-basis financial statement.)

* * * * *

* * * * *

Investments in marketable securities are reported at cost in the accompanying statements of assets, liabilities, and fund balances—income tax-basis. Donated securities are reported at their fair values on the date of receipt. Gains and losses associated with the investments are recorded when realized. (From a tax-basis financial statement.)

Inventory

Inventories are stated at a lower of cost (first-in, first-out method) or market. Capitalized costs under IRC Section 263A are 5.86% of the total inventory. (From a tax-basis financial statement.)

Capitalized Interest

Author's note. The entity that made the following disclosure was a real estate development partnership.

Construction period interest and real estate taxes are capitalized and amortized over ten years for expenses incurred prior to 1987. Post 1987 interest is allocated to construction costs, and is depreciated over the life of the asset. (From a tax-basis financial statement.)

Advertising

Author's note. Under generally accepted accounting principles, an entity is required to disclose the amount of advertising expense. In the following example, the entity elected to disclose advertising expense as a percentage of total sales rather than an actual dollar amount. This is an acceptable OCBOA disclosure because it communicates the substance of the GAAP requirement.

The Company expenses advertising as the costs are incurred. Advertising expense was approximately 1% of net sales for each of the years ended September 30, 199X and 199Y.

DISCLOSURES RELATED TO FINANCIAL STATEMENT ITEMS

Author's Note. As described in chapter 3 of this publication, SAS No. 62 states that when the financial statements contain items that are the same as or similar to those in statements prepared in conformity with GAAP, "similar informative disclosures are appropriate." Interpretation 14 of SAS No. 62 clarifies that, in these situations, OCBOA financial statements should provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure.

In practice, most OCBOA financial statements include disclosures that are almost identical to the GAAP disclosure requirements. However, with the issuance of Interpretation 14, an increasing number of OCBOA disclosures may substitute qualitative information for some of the quantitative information required by GAAP.

ASSETS

Market Value of Investments

At June 30, 199X and 199Y investments consisted of the following:

	199X	199Y
Preferred Stock—Omaha Power & Light	$ 100,000	100,000
Certificates of Deposit	100,000	100,000
Nebraska Corn Warehouse	310,621	241,080
Planters Corn Oil Mill	187,839	146,116
Stock—Farmer's Supply Assoc.	1,989	1,989
	$ 700,449	589,185

The Company owns 4,000 shares of Omaha Power and Light Preferred Stock. These securities are carried at cost. The other investments represent equity in farming cooperatives. These are noninterest bearing and will mature at the election of the cooperative.

* * * * *

Investment securities consist of common stocks and are reported at cost in the accompanying statement of assets, liabilities, and equity—cash-basis. At June 30, 199X, the investment securities had a cost of $387,689, gross unrealized gains of $225,439, gross unrealized losses of $12,375, and a fair value of $600,753, based on quoted market prices.

Note Receivable

Author's Note. GAAP requires the disclosure of long-term debt maturities for the five years subsequent to the balance sheet date. The following disclosure from a modified cash-basis financial statement, communicates the substance of that requirement and is considered adequate because the terms of the note are relatively simple and any user can easily determine a repayment schedule for the note.

The note receivable consists of a promissory note from Joe and Joan Davis dated April 27, 19XX. Weekly payments of $40 plus interest on unpaid principal balance are to be received until April 28, 19XX. The unpaid principal balance of $19,164 will balloon on that date. The note is secured by real estate recorded in Plat book 29, pate 118, of the Public Records of Some County, State. (From a cash-basis financial statement.)

Contributions Receivable

Author's Note. GAAP requires not-for-profit organizations to measure contributions receivable at their fair value. For contributions that will be received over a period of time greater than one year, fair value should be estimated using the present value of estimated future cash flows. The following disclosure was taken from a tax-basis financial statement. By providing information about the scheduled receipt of the contributions, the entity allows the financial statement users to estimate the fair value of the contributions using an appropriate discount rate.

Contributions receivable are reported at the gross amount the Organization expects to receive. At June 30, 19X0, the contributions receivable are scheduled to be collected as follows:

Year Ending June 30	Amount
19X1	$ 36,176
19X2	13,548
19X3	2,391
19X4	4,171
	$ 56,286

Trade Accounts Receivable

The accounts receivable aging at December 31, 199X is as follows:

Current	$ 399,143
31–60 days	52,413
61–90 days	9,407
> 90 days	1,344
	$ 462,307

(From a tax-basis financial statement.)

Inventory

At December 31, 199X and 199Y, inventory consisted of the following.

	199X	199Y
Materials and supplies	$ 121,133	145,390
Work in process	179,306	138,649
Finished goods	151,906	146,158
	452,345	430,197
Section 263A adjustment under TRA 86	68,278	52,823
	$ 520,623	483,020

(From a tax-basis financial statement.)

* * * * *

Finished goods account for approximately 86% and 91% of total inventory balances at December 31, 199X and 199Y, respectively. The remaining inventory amounts consist of raw and work in process in approximately equal proportions. (From a modified cash-basis financial statement.)

Step-up in Basis of Assets

Author's Note. As a result of the matter discussed below, the auditors modified their report for a departure from the cash-basis of accounting. Alternatively, the auditors might have considered whether the financial statements were, in fact, prepared on the tax-basis. If so, they might have been described as such, eliminating the need to modify the audit report.

On June 15, 198X, A. B. Jones sold her 48 percent interest in the Partnership to four other individuals, resulting in a 12 percent share each. For tax reporting purposes under Section 754 of the IRS Code, the new partners' basis in the property is the book value of the assets, plus 48 percent of the difference between fair market value and book value of all assets less liabilities at the time of the transaction.

This difference in valuation of the assets is depreciable only to the new partners. The additional depreciation amounted to $35,414 for each of the years ended December 31, 199X and 199Y. A schedule of the valuation of the assets on June 15, 198X is as follows:

	Historical Cost	48% FMV Less Historical Cost	New Partners' Basis
Land	$ 317,175	$242,869	$ 560,044
Buildings	408,404	536,264	944,668
Trucks	109,349	19,854	129,203
Equipment	48,676	10,850	59,526
Furniture and fixtures	44,026	21,105	65,131
	$ 927,630	$830,942	$1,758,572

LIABILITIES AND EQUITY

Income Taxes for Tax-Basis Financial Statements

Author's Note. As discussed in chapter 3 of this publication, the overall objective in tax-basis financial statements is to present the entity's financial position and results of operations using the recognition and measurement guidelines provided by the tax laws. A tax-basis financial statement is not merely the entity's tax return reformatted into a financial statement. As a result, taxable income and owners' equity per the tax return may not agree to the amounts reported in the financial statements. Although not required, some entities choose to provide a reconciliation of the two amounts.

Note E—Reconciliation of Financial Statements to Tax Return

	Partners' Deficit	Net Loss
As reflected on 199X Partnership income tax return	$ (2,569,877)	$ (196,997)
Adjustment for tenant receivables		
Beginning of year	—	(4,864)
End of year	6,554	6,554
Accrued interest not taken as a deduction on tax return	(75,887)	(75,887)
As reflected in the accompanying financial statements	$ (2,639,210)	$ (271,194)

For income tax reporting purposes, unpaid interest has not been recorded as a deduction, but has been reflected as deferred interest. For HUD regulatory reporting purposes, this interest has been recorded as an expense and as an increase to the partners' deficit. (From a tax-basis financial statement.)

* * * * *

Income Taxes

Income taxes for the years ended July 31, 199X and 199Y follows:

	199X	199Y
Federal	$ 59,000	$ 56,000
State	20,000	19,000
	$ 79,000	$ 75,000

A reconciliation of income before provision for income taxes to federal taxable income follows:

Income before provision for income taxes	$ 166,766	$ 155,261
Adjustments to taxable income:		
ABC equity in net loss	9,601	7,663
Officers' life insurance	34,142	34,996
Other nondeductible expenses	3,246	4,247
State income taxes	(20,000)	(19,000)
Federal taxable income	$ 193,755	$ 183,167

The Company's income tax returns have never been examined by the Internal Revenue Service. (From a tax-basis financial statement.)

* * * * *

For financial statement purposes, income taxes incurred are reflected in the financial statements when paid.

For the year ended December 31, 199X, the Company had an excess of expenses over revenues of $54,138 before income taxes. Accordingly, no income taxes were due for the year 199X.

In addition, at December 31, 199X, the company had available a net operating loss of approximately $65,000 which the Company carried back to prior years for Federal income tax purposes. This carryback resulted in a recovery of a portion of prior years taxes paid and such amounts were credited to operations as a tax benefit of $23,000 in 199Y. For State income tax purposes, the net operating loss can be carried forward for a period of three years. (From a cash-basis financial statement.)

* * * * *

The Company has federal net operating loss and contribution carryforwards that amounted to $73,239 and $52,364, respectively, available to offset future taxable federal income. The net operating loss and contribution carryforwards, if not used, will expire at various dates through the year 200X and at December 31, 199Y, respectfully. Such carryforwards are not available to reduce future state taxable income. (From a cash-basis financial statement.)

* * * * *

Loan Restrictions

The note payable and line of credit agreements contain certain financial restrictive covenants, summarized as follows:

- Tangible net worth to be equal to or greater than $1,200,000 through June 30, 199X and $1,500,000 through December 31, 199X
- Debt/tangible net worth to be less than 3.50 to 1
- Working capital to be greater than $200,000
- Current ratio to be greater than 1 to 1

(From a tax-basis financial statement.)

Equity

Distributable Income. As a result of the Company's election to be taxed as an S corporation, there are two components of retained earnings. Income earned prior to October 1, 1985, the date of the S corporation election, amounted to $8,168,364. The remainder represents earnings during the periods subsequent to the date of election. (From a tax-basis financial statement.)

REVENUES AND EXPENSES

Author's Note. GAAP requires the disclosure of future minimum rentals on noncancelable leases as of the balance sheet date. Rather than prepare a table of amounts, which is typical for GAAP financial statements, the entity that prepared the following disclosure provided summarized information to communicate the substance of the GAAP requirements.

At December 31, 199X and 199Y, approximately 50,000 square feet of the property is leased. In addition to paying fixed minimum annual rentals, the tenants have agreed to pay, as additional rent to the Partnership, a proportionate share of property insurance, real estate taxes and common area maintenance.

The leases have various terms ranging from two to seven years, with the last lease expiring January 200Z. Certain tenants have options to extend their leases. At December 31, 199X, future minimum rentals under noncancelable leases are approximately $2,800,000 in the aggregate and will generate approximately $500,000 of rental income per year for each of the next 5 years. (From a tax-basis financial statement.)

* * * * *

Author's Note. GAAP requires not-for-profit organizations to provide information about expenses reported by their functional classification, such as major classes of program services and supporting activities. The following disclosure from an OCBOA financial statement communicates the substance of that requirement.

The accompanying statements of activities—modified cash-basis, summarizes the costs of providing program and other activities on a natural basis. Approximately 83% of the Center's expenses relate to program services, 11% to supporting services, and 6% to fund raising activities.

DISCLOSURES RELATED TO ITEMS NOT INCLUDED IN THE FINANCIAL STATEMENTS

Author's Note: As described in chapter 3 of this publication, SAS No. 62 states that auditors should evaluate the adequacy of disclosures related to items not specifically identified on the face of the financial statements. These items include:

- *Related party transactions*
- *Restrictions on assets and owners' equity*
- *Subsequent events*
- *Uncertainties*

In practice, most OCBOA financial statements include disclosures that are almost identical to the GAAP disclosure requirements for these items.

COMMITMENTS

Retirement Plans

The Company maintains a qualified profit sharing plan covering all eligible employees. The plan includes a deferred arrangement under section 401(k) of the Internal Revenue Code. The elective contributions to the 401(k) portion of the plan are funded by salary reductions of the participants. Company contributions to the plan are discretionary up to a maximum of 15% of wages paid and accrued for the year, and are generally based on net income.

Contributions for the years ended December 31, 199X and 199Y were:

[Detail not provided]

(From a tax-basis financial statement.)

* * * * *

Employees of the company participate in a Money Purchase Pension Plan sponsored by ABC Company. All employees not excluded by class are eligible to enter the Plan on the entry date coincident with or nearest the completion of two years of service and attainment of age 21. For the plan year ending September 31, 199X and 199Y, the company will contribute $10,970 and $10,800, respectively, on behalf of its employees. These amounts have been paid at December 31, 199X and 199Y. (From a cash-basis financial statement.)

* * * * *

The pension commitments of the Company are for union employees covered under union agreements and for nonunion employees under a profit sharing plan in which contributions are discretionary by the Board of Directors. The Company made no contribution to the profit sharing plan for the six months ended June 30, 199X. (From a cash-basis financial statement.)

* * * * *

The Nonprofit Arts Council participates in two State Retirement Plans. One plan is a noncontributory defined benefit plan. The second plan is a defined contribution plan which contains a 401(k) elective deferral provision. The Council is required to contribute 1.5% of eligible compensation into this plan. The 401(k) elective deferral provision allows participants to receive additional contributions into the plan in lieu of receiving compensation. The some State Retirement Plan, being a State plan, is exempt from many of the ERISA report and disclosure requirements. The plan covers two full-time employees whose salaries are fully funded by the Council. It also partially covers four other full-time employees whose salaries are partially funded by the State. The total contributions to the plans by the Council during the year ended June 30, 199X were approximately $21,000. (From a cash-basis financial statement.)

Lease Arrangements

The Company has entered into various vehicle and equipment leases payable in aggregate monthly payments of $6,135, expiring on various dates through November, 1996. Total lease expense for the years ended December 31, 199X and 199Y was $73,539 and $69,764, respectively. Future minimum lease payments are as follows:

[Detail not provided]

(From a tax-basis financial statement.)

* * * * *

The Partnership has a lease and option to purchase land presently used for parking. The terms of the lease call for monthly minimum rental payments, adjusted every third year based on the consumer price index, until March 31, 20XX. The Partnership is liable for all property taxes, insurance and assessments relating to the land. At December 31, 199X, the minimum rental payments were $675 per month. The Partnership may purchase the land at the end of the lease term for $60,000.

At the inception of the lease there was not likely the Partnership would exercise the option to purchase the land at the end of the lease term. Therefore, the lease has been classified as an operating lease. (From a tax-basis financial statement.)

Unreported Health Claims

Author's Note. The following was disclosed in the notes of a welfare fund that issued tax-basis financial statements.

Plan liabilities for health claims incurred but not reported by participants at December 31, 199X and 199Y have been estimated by management to be approximately $171,000 and $215,000, respectively.

Provisions of the plan provide for participants, who terminate employment with a contributing employer and cease to become an employee, as defined, to receive a fifty percent lump-sum distribution of their Reserve Dollar Bank. In certain circumstances, upon retirement, they may be eligible to receive a hundred percent distribution of their Reserve Dollar Bank less any administration cost. Lump-sum distributions amounted to $25,500 in 199X and $8,750 in 199Y.

Future Construction

The Company plans to construct an additional building adjacent to its current facility. Estimated costs to complete are $275,000 to $300,000. (From a cash-basis financial statement.)

CONTINGENCIES

The Company has been named in lawsuits that involve accidents on ladders allegedly sold by the Company. The possible loss from these lawsuits could range between $150,000 and $250,000. Management believes these lawsuits are without merit and the resulting liability, if any, will not have a material adverse effect on the company's financial position. (From a tax-basis financial statement.)

* * * * *

The partnership is involved in an investigation by the Colorado Division of Environmental Response and Remediation (DERR) because a parcel of property once owned by the partnership is suspected of having leaking underground storage tanks located on it. Although the partnership denies responsibility for the gasoline that has contaminated the water table, the DERR maintains that the partnership is one of a number of responsible parties.

Due to the fact that the investigation is still in its preliminary stages, no estimate could be derived for the amount of loss the partnership could be liable for. The DERR continues to investigate the matter. (From a cash-basis financial statement.)

* * * * *

The Company is involved in several legal matters contending liability relating to soil contamination. One matter was a lawsuit that was settled shortly after December 31, 199X wherein the Company agreed to pay $54,167 toward the soil contamination clean-up costs. For the remaining unrelated matters, no amount, if any, of potential liability can be determined as of the balance sheet date. (From a tax-basis financial statement.)

* * * * *

In 1995, the Partnership and the general partner were advised by counsel for certain of the limited partners that those limited partners were seeking a return of the capital which they contributed. The Partnership and the general partner have received no further communication from the limited partners' counsel as to the further pursuit of the threatened litigation. (From a tax-basis financial statement).

RESTRICTIONS

Smith Farms, Inc., together with Billy Smith, Bobby Smith, and Jimmy Smith, have a $1,900,000 mortgage note with CountryBank. The money has been borrowed personally by the three stockholders of the Corporation and is secured by land owned personally by them. The mortgage is due November 30, 199X with interest charged at 1/2% above prime.

One of the stipulations in the note is that Smith Farms, Inc. will not create any liens or other encumbrances other than currently exist on real or personal property. The corporation does not expect to make payments on this note, but that all payments will be made by the stockholders individually.

In addition to the mortgage note, each stockholder and their respective spouse have a line of credit from CountryBank in the amount of $2,250,000 each. This line of credit is guaranteed by the Corporation. The terms for the line-of-credit loan are interest charged at prime and maturity date to be October 3, 199X.

Outstanding Balances:	199X	199Y
Mortgage note	$ 1,520,000	$ 1,900,000
Line of credit	4,350,000	1,500,000

(From a modified cash-basis financial statement.)

RELATED PARTY TRANSACTIONS

Author's Note. The following disclosure was taken from the financial statements of an entity in the health care industry.

In connection with the operation of the Magnetic Resonance Imaging equipment, the Company entered into an agreement with ABC to provide medical services as an independent contractor. The shareholders of the Company are the same as the shareholders of ABC. This relationship is an ongoing one with either party having the right to terminate the agreement upon sixty days written notice.

Effective December 1, 199X and June 1, 199Y, respectively, the parties have agreed that ABC was to receive a professional fee of $200 per MRI treatment. In addition, they will continue to receive sixteen and two-thirds (16 2/3%) percent on the Company's patient receipts collected after December 1, 199X but applicable to professional services rendered prior to December 1, 199X.

At December 31. 199X and 199Y, approximately $2,200 and $29,000 were due to ABC for professional service fees due under this agreement for patients receipts collected but not remitted. (From a cash-basis financial statement).

SUBSEQUENT EVENTS

On January 4, 199Z, the Company purchased certain assets of ABC Inc., an Iowa corporation. The purchase price was $545,000. The assets purchased consist of accounts receivable, fixed assets, vehicles, supplies, furniture and fixtures, other assets, and a one-year covenant not to compete.

The purchase price was financed with a term note for $545,000. The note is secured by the guarantee of the sole stockholder and collateral identified in a security agreement dated June 1, 199X. (From a modified cash-basis financial statement.)

* * * * *

In July, 199Y, the Company entered into a purchase and sale agreement which provided for the purchase of a building in the amount of $215,000 and the assumption of a lease of the land on which the building is located. The building purchase was executed on September 28, 199Y and was financed in part by a $160,000 note payable to a bank. The terms of the note provide for quarterly interest payments at the bank's prime rate through the note maturity date. A $60,000 principal payment as due and made in December 199Y, and the remaining balance is due in September 199X. The note is secured by a leasehold deed of trust and security agreement and an assignment of rents and leases.

The assumed lease referred to above is an operating lease which requires annual payments of approximately $9,800 through September 199X. The company has the option to terminate the lease in March 19XX. If the lease is not terminated, the annual payment will be revised to reflect six percent of the value of the land which will be determined as set forth in the lease agreement. (From a modified cash-basis financial statement.)

OTHER DISCLOSURES

Change to OCBOA in Current Year

Author's Note. As described in chapter 3 of this publication, there are several different methods for disclosing information relating to a change in the basis of accounting. The following disclosure shows one of those methods. The financial statements presented one year only.

In previous years, the Company prepared its financial statements using generally accepted accounting principles. In addition, the financial statements presented the financial activity of the Project and did not reflect the transactions of the Partnership entity.

Effective for periods commencing January 1, 199X, the Partnership will prepare its financial statements using the income tax-basis of accounting (refer to note A). The financial statements will reflect the financial activity of the Partnership entity.

The deficit in Partners' equity as of January 1, 199X has been adjusted to reflect all Partnership assets and liabilities—income tax-basis, resulting in an increase to the deficit of $(672,871).

A summary of significant components of this adjustment follows:

Reduction to the net book value (cost less accumulated depreciation and amortization) of property and equipment and loan costs	$ (885,341)
Change in the balance due to/from affiliates as previously reported	236,404
Other	(23,934)
	$ 672,871

(From a tax-basis financial statement.)

Vulnerabilities Due to Concentrations

Author's Note. GAAP requires entities to disclose risks of loss due to concentrations. The required disclosures should be made if all of the following criteria are met:

- *The concentration exists at the date of the financial statements.*

- *The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.*

- *It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.*

In practice, many of the disclosures relating to concentrations found in OCBOA statements are identical to what would be disclosed in financial statements prepared in accordance with GAAP.

Net sales for the years ended July 31, 199X and 199Y include sales to the following major customers (each of which accounted for more than 10% of the total net sales of the company for those years).

	Amount of Net Sales Year Ended July 31,		Trade Receivable Balance July 31,	
	199X	199Y	199X	199Y
Customer A	$ 2,055,774	$1,400,032	$ 250,883	$171,838
Customer B	678,297	746,535	60,026	57,301
	$ 2,734,071	$2,146,567	$ 310,909	$229,139

(From a tax-basis financial statement.)

* * * * *

The Corporation grants credit to individuals, insurance companies, and to state and federal government agencies. At December 31, 199X and 199Y the percentage of receivables due from state and federal government agencies amounted to 63.4% and 62.3%, respectively. (From a tax-basis financial statement.)

* * * * *

Approximately 36% of raw material purchases for 199X were from a single supplier. (From a tax-basis financial statement.)

* * * * *

A significant portion of the Company's sales are made to one customer, the loss of which would have a materially adverse effect on the Company. During the years ended December 31, 199X and 199Y, the customer accounted for approximately 58% and 53% of revenues, respectively. (From a tax-basis financial statement.)

Investments Accounted for Using the Equity Method

Author's Note. As discussed in chapter 3 of this publication, there is no authoritative guidance on whether consolidation accounting under GAAP should be applied to OCBOA financial statements. In the following example, the entity accounted for its controlling interest in another entity using the equity method, rather than presenting consolidated financial statements. Additional information about the other entity was provided in the notes to the financial statements.

Typically, it is preferable to present the summarized financial information included in the notes on the same basis of accounting used to prepare the financial statements.

On November 15, 19AA, the Company purchased a 40% interest for $80,000 in ABC Company, a Montana corporation. On June 8, 19BB, an additional 10.5% interest was acquired at a cost of $29,400. During the year ended July 31, 199X, the percentage of interest in ABC increased to 74.3% due to stock redemptions. This investment is accounted for as follows:

	199X	199Y
Investment at original cost, 202 shares	$ 109,400	$ 109,400
Equity in net income (loss) at July 31:		
Total of prior years	6,400	14,063
Current year	(9,601)	(7,663)
	(3,201)	6,400
Investment at carrying value	$ 106,199	$ 115,800
Company's share of the underlying equity in net assets	$ 134,6340	$ 115,854

The significant difference between the investment amount carried in these financial statements and the Company's share of the underlying equity in the net assets of ABC is due to stock redemptions.

The following summarized financial statement information for ABC was prepared using the modified cash-basis of accounting described in Note A.

Assets	199X	199Y
Real estate	$ 529,745	$ 515,614
Cash and other assets	21,674	39,827
Total Assets	$ 551,419	$ 555,441
Liabilities		
Mortgage note payable	$ 370,196	$ 396,100
Other liabilities	5,164	3,413
Total Liabilities	370,215	399,513
Stockholders equity	181,204	155,928
	$ 551,419	$ 555,441
Rental income	$ 985,347	$ 953,992
Rental expense	$ 995,485	$ 966,841
Other (expenses) income	(2,790)	2,530
Net loss	$ (12,928)	$ (10,319)

(From a modified cash-basis financial statement.)

Business Acquisition

Effective May 17, 199X, the company acquired certain assets of BCE, Inc., a home medical equipment company. The assets acquired were:

Accounts receivable	$ 470,000
Rental equipment	329,000
Inventory	95,000
Autos	13,000
	$ 907,000

The purchased was financed with a bank term note, described in Note C. (From a tax-basis financial statement.)

Sale of Receivables

The company has sold customer installment contracts to SecondBank. Substantially all of the contracts are without recourse. The bank retains portions of the contract amounts as reserves that are released to the company as the customers make monthly payments. Refunds of the reserves in the event or default or early payment are recognized as incurred. Management anticipates no significant losses under these arrangements, and, accordingly, no provision has been made for future losses on contracts outstanding. (From a tax-basis financial statement.)

Foreign Currency Translation

Author's Note. The following disclosure was included in a note to a tax-basis financial statement. The foreign currency gain was displayed as separate line item below income from operations on the statement of revenues and expenses.

Summary of Significant Accounting Policies—Foreign Currency Translation

Foreign currency transactions are translated to U.S. currency at the rates of exchange at the dates of the transactions. Interest expense on loans denominated in other currencies is computed at the exchange rate in effect at year end. The Partnership recognizes foreign currency gains or losses on its loan and accrued interest based on exchange rates at its year end.

Notes Payable

A 225,000,000 Spanish peseta note is due to Spanish Bank BV. Interest is accrued and compounded annually on the anniversary of each draw down at a rate of 18% p.a. The note is secured by the limited partner's rights and interests in the net profits of the Partnership and any distribution of any nature by the Partnership which the limited partner is or may be entitled to receive.

In 199X, for financial statement purposes, the Partnership recognized a foreign currency gain of $487,062 for this note based on the December 31, 199X exchange rate of 142.86 Spanish pesetas to $1 U.S.

Functional Expenses

Author's Note. Certain not-for-profit organizations are required to present a statement of functional expenses as part of their basic financial statements. The required statement is presented in a matrix format to indicate how the various expenses in their natural classification (e.g., salaries, rent, office supplies, etc.) have been allocated to the entity's activities (e.g., programs, fund-raising, support, etc.).

The following disclosures were provided by not-for-profit organizations that did not include a statement of functional expenses in their basic financial statements. Instead, the expenses were presented in their natural classification, and the following notes communicated the substance of the GAAP presentation requirement.

The accompanying statement of revenues, expenses and net assets (tax-basis) summarizes the Center's expenses according to their natural classification. During the fiscal year ended June 30, 199X, approximately 70% of the Center's expenses relate to program services, 18% to supporting services, and 12% to fundraising activities. (From a tax-basis financial statement.)

* * * * *

The Organization incurs costs to provide program services and support. Expenses for the year ended August 31, 199X are summarized as follows.

Program Services		
Parent aide	$ 333,674	36%
Parent education	202,486	22%
Public awareness	143,282	15%
Community Education	89,984	10%
Total program services	$ 769,426	83%
Fundraising and Support		
Management and general	$ 100,718	11%
Fundraising	55,264	6%
Total program services	155,982	17%
Total expenses	$ 925,408	100%

CHAPTER 7
EXAMPLE REPORT MODIFICATIONS

Reporting on OCBOA financial statements is discussed in detail in chapter 4. That chapter includes examples of standard, unmodified reports for both cash- and tax-basis financial statements. In practice, the more common report modifications include those related to—

- Departure from the OCBOA
- Going concern
- Emphasis of a matter

DEPARTURE FROM THE OCBOA

Departure From the Cash-Basis of Accounting—Review Report

Author's Note. The following is an example of a report modification for a departure from the cash-basis of accounting. The departure relates to using tax depreciation methods in a modified cash-basis financial statements. If other recognition and measurement principles also followed the tax rules, an alternative would have been to describe the financial statements as tax-basis and eliminate the report modification.

> [First two paragraphs standard review report]
>
> Based on our review, with the exception of the matter described in the following paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the cash-basis of accounting, as described in Note 1.
>
> As disclosed in Note 1 to the financial statements, the cash-basis of accounting requires that property and equipment be depreciated on the straight-line method over the expected useful lives of the assets. Management has informed us that the property and equipment are depreciated on the declining balance, ACRS, MACRS, and straight-line methods over the prescribed cost recovery periods according to federal income tax regulations. The effect of this departure from the cash-basis of accounting has not been determined.

* * * * *

Author's Note. The following is an example of a report modification for a departure from the cash-basis of accounting. The entity was a not-for-profit YMCA.

[First two paragraphs standard review report]

Based on our review, with the exception of the matter described in the following paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the cash-basis of accounting, as described in Note 1.

As discussed in Note 1 to the financial statements, the capitalization of property, plant, and equipment and the recording of depreciation over the estimated useful lives of such assets is a generally accepted modification of the cash-basis of accounting. Management has informed us that a provision for depreciation has not been included in the accompanying financial statements. The effect of this departure from the cash-basis of accounting on the accompanying financial statements has not been determined.

Departure from Tax-Basis—Review Report

Author's Note. As discussed in chapter 2 of this publication, in some instances it may be necessary to depart from the stated basis of accounting in order to make the financial statements more meaningful. In the following example, the entity departed from tax-basis of accounting to defer the recognition of certain revenue. The following illustrates the reporting under that situation.

[First two paragraphs standard review report]

Based on our review, with the exception of the matter described in the following paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with the income tax-basis of accounting.

The Partnership's financial statements have been modified to defer recognition of unearned dues, which should be included in partners' capital and the expenses in excess of revenue to conform with the basis of accounting used in preparing the Partnership's income tax return. If the effects of these modifications were included, partners' capital would be increased by approximately $85,000 and $80,000 as of December 31, 199X and 199Y, respectively. The revenues in excess of expenses would be increased by approximately $25,000 and $20,000 in 199X and 199Y, respectively.

GOING CONCERN

Going Concern Considerations—Audit

Author's Note. As discussed in chapter 4 of this publication, auditors are required to add an explanatory paragraph to their report when substantial doubt about the entity's ability to continue as a going concern exists. This requirement exists for both OCBOA and GAAP financial statements.

The accompanying financial statements have been prepared assuming that the Partnership will continue as a going concern. As discussed in Note C to the financial statements, because of insufficient cash flows, the Partnership has been unable to meet its debt service requirements. Also, the Partnership continued to experience operating losses during 199X. These conditions raise substantial doubt about the Partnership's ability to continue as a going concern. Management's plans in regard to these matters are also discussed in Note C. These financial statements do not include any adjustments that might result from the outcome of this uncertainty. (From a tax-basis financial statement.)

(The following note was included in the financial statements.)

Note C—Going Concern

The Partnership is three months in arrears with its mortgage payments. The mortgagee has indicated that they have elected to assign the mortgage to HUD. In addition, the Partnership experienced a substantial operating loss for the year ended December 31, 199X.

These circumstances raise substantial doubt about the Partnership's ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

The Partnership has applied for and received Section 8 rental assistance under the Loan Management Set Aside Program.

The Partnership intends to apply to HUD for a provisional workout arrangement once the assignment has been approved.

Going Concern Considerations—Compilation

Author's Note. An explanatory paragraph for going concern matters is optional but not required for a compilation or review report. If going concern matters are not disclosed adequately in the financial statements, then a compilation or review report should be modified to indicate a departure from the OCBOA.

As discussed in Note 4, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying income-tax-basis financial statements do not include any adjustments that might be necessary should the Company be unable to continue as a going concern. (From a tax-basis financial statement.)

(The following note was included in the financial statements.)

Note 4—Going Concern

During 199X, two tenants accounted for approximately $150,000 of the Company's rental revenue (approximately 60% of total 199X revenues). The lease agreements for these tenants expired in 199Y and were not renewed or replaced. The Company's ability to meet cash flow requirements was adversely affected and, as discussed in Note 2, the Company has defaulted on its mortgage.

These factors create an uncertainty as to the Company's ability to continue as a going concern. Management is pursuing replacement tenants, but it is likely that the lender will foreclose on the rental property. The financial statements do not include any adjustments that might be necessary should the Company be unable to continue as a going concern.

EMPHASIS OF A MATTER

Author's Note. In any report on the financial statements (audit, review, or compilation), the auditor or accountant may emphasize a matter regarding the financial statements. Emphasis of a matter paragraphs are never required, but may be added solely at the auditor's or accountant's discretion. Examples of matters that may warrant an emphasis of a matter paragraph include:

- *That the entity is a component of a larger business enterprise.*
- *That the entity has had significant transactions with related parties.*
- *Unusually important subsequent events.*

Emphasis of a Matter—Change in Basis of Accounting

Author's Note. A change in the basis of accounting, for example, from GAAP to OCBOA, is not an accounting change that requires a report modification because of an inconsistent application of accounting principle. However, an auditor or accountant is not precluded from adding an explanatory paragraph to emphasize the matter.

[First three paragraphs of standard audit report]

As described in Note D to the financial statements, in 199X the Company adopted the income tax-basis of accounting, which is described in Note A. Partners' capital accounts as of December 31, 199Y have been restated to reflect this change.

Emphasis of a Matter—Reporting Entity

[First two paragraphs standard compilation report]

These financial statements are the financial statements of XYZ Partnership only and do not include the accounts of other related business entities under common ownership or control, as described in Note 1.

(The financial statements included the following note.)

Note 1—Related Business Entities

The Partnership is related to other business entities through common ownership or control. These financial statements do not include any other related business entities which are under common ownership or in which the partners have a direct or indirect controlling financial interest. The financial effects of control of two or more business enterprises by common ownership are more appropriately reflected in combined financial statements presented in accordance with generally accepted principles of accounting applicable to consolidations.

Dissolution of the Entity—Compilation

[First two paragraphs standard compilation report]

The partnership sold the property on August 31, 199X and filed a final U.S. Partnership Return of Income as of December 31, 199X. The 199X financial statements reflect this sale and the effective dissolution of the partnership as of December 31, 199X.

APPENDIX

OCBOA FINANCIAL STATEMENT DISCLOSURE CHECKLIST

The following checklist has been developed for use with general purpose cash- and tax-basis financial statements. It should be used by, or under the supervision of, people having adequate technical training and proficiency in the application of cash- and tax-basis accounting principles, generally accepted accounting principles, generally accepted auditing standards, and statements on standards for accounting and review services.

The following checklist does not represent minimum requirements and does not purport to be all-inclusive. You are urged to refer directly to applicable authoritative pronouncements when appropriate.

Explanation of References

AU=	Section number in AICPA *Professional Standards* (vol. 1)
SAS=	AICPA Statement on Auditing Standards
SSARS=	AICPA Statement on Standards for Accounting and Review Services
AC=	Section number in FASB *Current Text*
SFAS=	Statement of Financial Accounting Standards
ARB=	Accounting Research Bulletin
APB=	Accounting Principles Board Opinion
FASBI=	Financial Accounting Standards Board Interpretation
SOP=	AICPA Statement of Position
TB=	Technical Bulletin issued by the staff of the FASB
TPA=	AICPA Technical Practice Aid

The checklist has been updated as appropriate through the following pronouncements.

- SFAS No. 132
- FASB TB 94-1
- FASBI No. 42
- AICPA SOP 98-3

OCBOA FINANCIAL STATEMENT DISCLOSURE CHECKLIST

	Yes	No	N/A
1. Are the financial statements appropriately titled? [SAS 62, par. 7(AU 623.07, TPA 1500.04]	____	____	____
2. Are required disclosures of significant accounting policies made? [SAS 62, par. 10 (AU 623.10); AR 100 fnt 4, (SSARS7)]	____	____	____
3. Do the financial statements describe the basis of accounting used and its primary differences from GAAP? [SAS 62 par. 10 (AU 623.10)]	____	____	____
4. For tax-basis financial statements, is disclosure made that the amounts reported in the financial statements may require change at a later date upon IRS examination?	____	____	____
5. Have comparative financial statements been considered?	____	____	____
a. Are the notes and other disclosures included in the financial statements of the preceding years repeated, or at least referred to, to the extent that they continue to be of significance? [ARB 43, Ch. 2A, par. 2 (AC F43.102)]	____	____	____
b. If changes have occurred in the manner of, or basis for, presenting corresponding items for two or more periods, are appropriate explanations of the changes disclosed? [ARB 43, Ch. 2A, par. 3 (AC F43.103)]	____	____	____
6. Are the following disclosures made, as appropriate for items not specifically identified on the face of the financial statements? [SAS 62, par. 10 (AU 623.10); SAS No. 62 Interpretation 14 (AU 9623.88); AR 100 fnt 4, (SSARS 7)]	____	____	____
a. Related-party transactions. [SFAS 57, pars. 2-4 (AC R36.102-104)]	____	____	____
b. Restrictions on assets and owners' equity [SFAS 5, pars. 18-19 (AC C59.120); ARB 43, Ch. 3A, par. 6 (AC B05.107)]	____	____	____
c. Subsequent events. [SFAS 5, par. 8 (AC C59.105); SAS 1, secs. 560.03-.07 and .09, and 561.01-.09 (AU 560.03-.07, .09 & 561.01-.10)]	____	____	____

	Yes	No	N/A
d. Uncertainties, including going-concern. [SAS 58 pars. 16-33 (AU 508.16-.33); SAS 59, pars. 10-11 (AU 341.10-.11); Interpretation No. 11 of SSARS 1 (AR9100.33)]	____	____	____
7. Has consideration been given to disclosing items that are the same or similar to those in GAAP statements? (Disclosures should either provide the relevant information required by GAAP disclosures or communicate their substance). [SAS 62, par. 10, (AU 623.10); SAS No. 62 Interpretation 14 (AU 9623.88); AR 100 fnt. 4 (SSARS 7)]	____	____	____
Common items include:			
a. Nature and effect of unusual items. APB 30, par. 26 (AC I22.101); TB 82-1, par. 6 (AC I27.505)]	____	____	____
b. Accounting changes and correction of an error. [APB 20, pars. 17, 33 and 36-37 (AC A35.105); TPA 9210.10]	____	____	____
c. Business combinations. [APB 16, pars. 45-48. 63-96 (AC B50.104-.107, .122-.147, .164-.166); SFAS 38, par. 10 (AC B50.166); SFAS 79. pars. 4-6 (AC B50.165)]	____	____	____
d. Consolidations. [ARB 51, par. 5 (AC C51.108); APB 22, par. 14 (AC A10.107)]	____	____	____
e. Commitments and contingencies. [SFAS 5; FASBI 34, pars. 1-3 (AC C59.114); ARB 43, ch. 4, par. 17 (AC I78.121-.122)]	____	____	____
f. Accounts receivable (including allowance for bad debts). [ARB 43, ch. 1A, par. 5 (AC R36.105); APB 12, par. 3 (AC V18.102)]	____	____	____
g. Financial instruments.			
(1) Fair value. (Per Interpretation 14, not required for tax-basis financial statements). [SFAS 107, pars. 10-15 (AC F25.115C-F, I-K); SFAS 119, par. 8 (AC F25.115L)]	____	____	____
(2) Concentration of credit risk, including cash balances in excess of insured limits. [SFAS 105, par. 20]	____	____	____

	Yes	No	N/A
(3) Off-balance-sheet risk. [SFAS 105, pars. 17-19 (AC F25.112-.115)]	____	____	____
h. Inventories. [ARB 43, ch. 3A, pars. 4 and 9 and ch. 4, pars. 3-16 (AC B05.107A, I78.110-.117, .119-.120); APB 22, par. 14 (AC A10.107)]	____	____	____
i. Property, plant and equipment. [APB 12, pars. 5a-5d (AC D40.105); APB 22, par. 14 (AC A10.107)]	____	____	____
j. Leases. [SFAS 13, pars. 13, 16 and 23 (AC L10.112 & .119); SFAS 29, par. 12]	____	____	____
k. Current liabilities. [ARB 43, ch. 1, par. 5 and ch. 3A, pars. 7-8 (AC B05.402); SFAS 78, par. 5 (AC B05.109A & .118)]	____	____	____
l. Notes payable and long-term debt. [SFAS 5, pars. 18-19 (AC C59.150); SFAS 47, par. 10b (AC C32.105); ARB 43 ch. 3A, pars. 7-8; SFAS 6, par. 15 (AC B05.118); SFAS 78, par. 5; FASBI 8, par. 3 (AC B05.117); TB 79-3 (AC B05.501-.503)]	____	____	____
m. Income taxes.			
(1) Explanation if income tax not provided or if unusual relationship between income tax and income before income taxes.	____	____	____
(2) Amount of tax credit.	____	____	____
(3) Amount of unused NOL or other tax carryovers and their expiration dates. [SFAS 109, pars. 43-46 and 48]	____	____	____
n. Pensions, postemployment benefits, and postretirement benefits. [SFAS 132 pars. 5 and 8; SFAS 112, par. 24]	____	____	____

	Yes	No	N/A
o. Risks and uncertainties.	____	____	____
(1) Nature of operations. [SOP 94-6, par. 10]	____	____	____
(2) Use of estimates. [SOP 94-6, par. 11]	____	____	____
(3) Significant estimates. [SOP 94-6, par. 13—15]	____	____	____
(4) Current vulnerability due to concentrations. [SOP 94-6, par. 21—24]	____	____	____